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Central banks are losing credibility

By John Taylor

Whether or not one believes that the €750bn European rescue plan will stabilise financial markets, its consequences for Europe's economies are surely negative. Indeed, while many cheered the initial rebound in equity markets, the reactions in currency markets on the first trading day after the announcement were a harbinger of these negative consequences: the initial gains of the euro were erased by the end of the trading session.

Of course, the bail-out for holders of Greek government debt – and now possibly Spanish and Portuguese government debt – raises familiar problems of moral hazard that will increase risk-taking and encourage irresponsible government policy in the future. The loans and loan guarantees from other countries in Europe do not deal with the simple fact that the Greek government cannot service its debt and will eventually need to restructure it. At best the package gives officials some breathing room as they endeavour to reduce deficits and eventually restructure debts, though it is more likely that the adjustment problem will be made worse by being pushed down the road.

But most worrisome for the euro, and the likely reason for its remarkable reversal in the currency markets on day one, is the agreement by the European Central Bank to buy the debt of the countries with troublesome debt burdens, just days after it said it would not engage in such purchases. This agreement raises questions about the independence of the ECB, thereby creating political obstacles to the conduct of good monetary policy in the future.

Buying the distressed debt of some countries is not monetary policy as conventionally defined, but rather an effort to allocate funds to some creditors and borrowers and not others. Unlike a central bank's responsibility to provide for price stability and thereby economic growth, there is no established rationale that such credit allocation policy should be the responsibility of an independent agency of government. Most likely the purchases will be financed by money creation – quantitative easing – as the ECB expands its balance sheet. If Angela Merkel, Germany's chancellor, is right that the ECB will not increase the money supply, then it will have to sell other governments' securities to offset the purchases of Greek debt. This will further increase the tax burden for citizens of those other countries. Of course, Ms Merkel's comment about how the ECB should set the money supply is another indicator of reduced independence.

Unfortunately, the ECB's change of mind about these purchases raises questions about its credibility. Clearly the bank was under pressure from European governments. My understanding is that the governments pointed to the US. You can imagine the phone conversations between Brussels and Frankfurt. "The Fed helped the US Treasury conduct its bail-out policy during their financial crisis; why can't the ECB help us in our bail-out?" Even the Fed's "whatever it takes" mantra was being repeated in Brussels last weekend. In my view we are definitely seeing contagion, but it is a contagion of deviations from the independent and credible monetary policy that has served us well in the past. We have seen this recently elsewhere: in 2008 the Reserve Bank of India was evidently pressured to engage in credit allocation by politicians arguing that other central banks were doing it.

Making matters worse for the future of monetary policy is the Fed's active participation in the European bail-out. The US central bank agreed to provide loans – technically called swaps – to the ECB so that the ECB can more easily make dollar loans in the European markets. In order to loan dollars to the ECB, the Fed will have to increase the size of its own balance sheet. Such swap loans were made to the ECB back in December 2007, but they did not help end the crisis or prevent the panic of autumn 2008. Instead, they merely delayed inevitable action to deal with deteriorating bank balance sheets, thereby making the panic worse.

Was it necessary for the Fed to participate in the European bail-out? At least as evidenced by quantitative measures such as the spread between 3-month Libor and the overnight index swap (OIS), the funding problem in the interbank markets is far less severe now than in December 2007. The international loans also raise questions about the Fed's independence at a time when many in Congress are calling for a complete audit of the Fed. Even though monetary policy does not warrant such an audit, extraordinary measures such as the loans to the ECB do. By taking these extraordinary measures, the Fed is losing some of its independence as well as adding to the perception that the ECB is losing its independence.

Europe's monetary union should not be viewed as the problem here. Things would be much worse if Greece left the eurozone and revived the drachma at a depreciated rate. This would make servicing debt even harder for the Greek government and for Greek private sector companies that had borrowed in euros or dollars, wiping out any short-term competitive advantage from the

depreciation. The best way to strengthen and preserve the monetary union is to restore the ECB's independence and credibility, which it earned the hard way over the first decade of its existence.

The writer, a professor of economics at Stanford and senior fellow at Stanford's Hoover Institution, is co-editor with Kenneth Scott and George Shultz of 'Ending Government Bailouts As We Know Them' (Hoover Press, 2010)

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