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The wrong doctors

Central bankers are putting all at risk

Richard Rahn | Tuesday, September 11, 2012

Central banks are being pressured by their political masters to solve a problem they cannot solve.

On Wednesday, a German court is going to rule whether the European Central Bank can buy an unlimited amount of debt from the national banks of the countries in the eurozone without violating German law. By week's end, the U.S. Federal Reserve likely will decide if it is going to engage in another round of massive debt buying.

Central banks such as the Fed create money. They do this directly or indirectly (through loans to banks) by buying the bonds that governments issue to pay their bills when they spend more than they take in from taxes. Most of the world's governments are running big deficits that they finance by issuing lots of bonds. These bonds are bought by individuals, businesses and other institutions, and by central banks.

When private parties buy government bonds, they do so with money they have saved. When a central bank buys a bond, normally from a bank, it can do so from money it simply creates -- in either paper or electronic form. The new money is a liability on the balance sheet of the central bank, which is collateralized by the bond it bought.

If a central bank creates money at a faster rate than the economy is producing new goods and services, this causes the value of the money to fall, which we call inflation. If the central bank creates too little money, its value will rise, which we call deflation.

As countries add more and more debt in relation to their gross domestic product, bond buyers demand higher interest rates to compensate for the risk that governments might default or inflate away the value of the currency. Higher interest rates make it more difficult for governments to service their debt, and they get into a death spiral of both ever-increasing debt and higher and higher interest costs.

To keep interest rates down, central banks have been buying government debt. However, this can only work up to the point where the money supply can be increased without causing a big inflation. Last week, the head of the European Central Bank said the institution would buy an unlimited amount of Spanish government debt in order to keep Spanish interest rates down. The problem with this action is that it will increase the inflation risk for all of the countries that use the euro and drive up interest rates for the more responsible countries such as Germany. Interest rates on Spanish government debt, which were about 6 percent, may go down, benefiting Spanish taxpayers, while interest rates on German government debt, which have been less than 2 percent, will rise, hurting German taxpayers.

There is an obvious limit to this game. The only way out is for the European governments to largely eliminate their deficits. So the European Central Bank says to Spain and the other countries: "We will only purchase your bonds if you promise to eliminate your deficits." The political leaders say "yes," but their countries are parliamentary democracies and their voters resist the required spending cuts. Greece, for example, has yet to make the most of its oft-repeated promised cuts.

The European Central Bank can reduce the general inflation risk by selling some of the German, French or other bonds it holds in order to pay for the Spanish bonds. This will cause German and French interest rates to rise, however, and will leave the bank with riskier collateral -- i.e., more Spanish bonds and fewer German bonds with which to back the euro.

In the United States, the Fed has not only been buying large quantities of government bonds, but also mortgaged-backed securities "guaranteed" by the U.S. government. There are a number of problems with this. Some U.S. government agencies and departments are guaranteeing the debt of other government agencies. The Fed, after all, is a U.S. government agency. So the only real "guarantee" is that of the Internal Revenue Service using its coercive police powers to pay for all of these debts by extracting taxes from what may be an unwilling public.

Another problem is that the Fed lists the value of the mortgage-backed securities it holds at their acquisition cost rather than their current market value as any private company, for good reason, would be required to do. The problem with the Fed accounting is that at least some of these securities will never be paid in full, leaving the taxpayer with the responsibility for the loss. The Fed does turn over its profits from the interest on the bonds to the Treasury, so the bad loans will probably just result in less profit to the Treasury -- again leaving the taxpayer on the hook for the difference.

The basic problem is that the world's major central banks are being pushed into trying to solve a problem -- extreme and persistent deficit spending by governments -- that they cannot solve. Unless elected politicians reduce government spending, we are doomed to be left with a world of economic stagnation or inflation, or both.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.