

Liquidity injections alone are not enough

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Monetary policy's various guises from near-zero short-term interest rates, to massive liquidity injections, to quantitative easing and its relatives have so far had no traction in this crisis. While the global economy is no longer shrinking at quite the speeds seen at the beginning of the year, it is still trapped in a bad recession.

The main reason for its longevity is the state of the banking sector. The [European Central Bank](#) has recently pumped €442bn (\$620bn, £380bn) in one-year liquidity into the system, but the money is not reaching the real economy. Japanese-style stagnation is no longer possible – it is already here. The only question is how long it will last. Even in an optimistic scenario, global economic growth will be weighed down by a combination of credit squeeze, rising unemployment, rising bankruptcies, rising default rates, and balance sheet adjustment in the household and financial sectors.

I would expect the US to have something approaching a genuine recovery at some point in the next decade, but probably not in 2010 or 2011. Judging by the co-ordination failure at the level of the European Union, the persistent failure to deal with the continent's 40 or so cross-border banks at European level, and in particular Germany's inability to sort out its toxic-asset contaminated Landesbanken, the economic prospects for the eurozone are infinitely worse.

From comments by senior central bankers in the US and Europe, I am sure they understand the gravity of the situation very well. Janet Yellen, present of the Federal Reserve Bank of San Francisco, warned last week that the recovery would be agonisingly slow, that unemployment could stay high for many years, and that interest rates might stay low for a long time.

I would also interpret the decidedly downbeat statement last week by [Jean-Claude Trichet](#), president of the European Central Bank, as a sign that the ECB is getting more worried – when others are getting more optimistic. In Europe, there is some evidence that the credit crunch has deteriorated in recent weeks. Much of that evidence is anecdotal, but these anecdotes are disquieting.

Companies who file for bankruptcy increasingly blame the banks, and the number of bankruptcies is rising rapidly. Only a fool would take comfort from the strength in economic indicators. During a financial crisis, these indicators could be a metric of its respondents' degree of delusion.

The problem is that the trillions of dollars and euros in liquidity are not getting through. There is no point in blaming the banks. Mr Trichet appealed to the banks to behave responsibly. Over the weekend, [German politicians](#) also made desperate and implausible threats against the banks unless they increased lending. Not only is this a waste of time but the banks are, in fact, behaving responsibly when they deny credit to customers whom they judge to have lost creditworthiness.

Left to its own devices, banking is inherently pro-cyclical. This is one of the reasons restoring the health of the banking sector by whatever means necessary is a precondition for an economic recovery. Liquidity injections by a central bank, however large, cannot restore health to the banking sector in a sufficiently short period of time if the underlying problem is lack of solvency. Nor do accounting tricks that allow banks to freeze their bad assets in bad banks without any resolution mechanism, such as the German law passed last week. And since the European economies are far more dependent on the banking sector than their Anglo-Saxon counterparts, the need to sort out the banking sector is even more urgent there.

The interactions between the financial sector and the real economy have both a short-term and a long-term, or structural, component. The European Commission's most recent [quarterly report on the eurozone](#) states bluntly that the crisis will lead to a permanent loss in economic output, unless EU member states begin to pursue very different kinds of economic policies. With several European countries now obsessing with premature crisis exit strategies, which may kick in as early as 2010, the chances of a vicious cycle of fading economic growth, falling tax receipts, deficit cuts and further output losses are high. If Ms Yellen is right about the US economy, there will be no bail-out of the European and Asian economies through the US consumer. If the situation persists even for only five years, it will lead to a structural slump for some of those export-reliant economies on the European continent.

The Europeans have a bigger task and they operate in a more difficult political environment. The economic policy framework of Europe's monetary union only barely succeeded during a normal economic cycle, during which its most important framework of policy co-ordination, the stability and growth pact, was dislodged. The policy framework proved utterly dysfunctional during this economic crisis, as leaders like Angela Merkel or Nicolas Sarkozy have resorted to their nationalist instincts. It would take an even bigger crisis for them to agree on a joint resolution strategy for the banking system.

There is a good chance they might get it.

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