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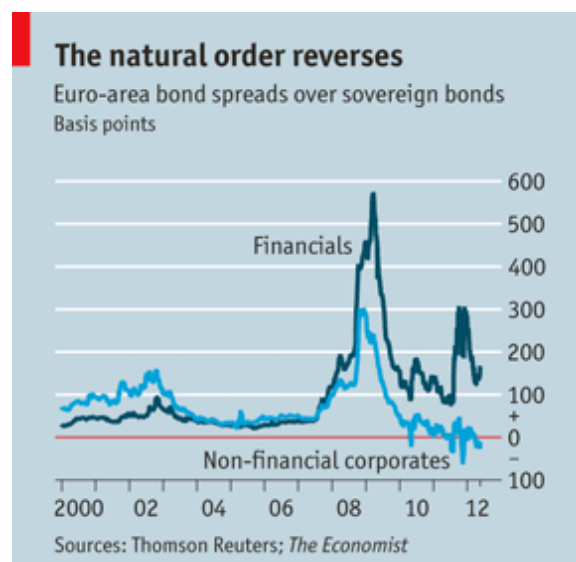
The nationalisation of markets

The rise of the financial-political complex

May 26th 2012 | from the print edition

EACH step taken by the authorities over the past five years has been designed to prop up the economy and save the financial system. But the cumulative effect has been the creeping nationalisation of markets. Central banks are the biggest players in many rich-world government-bond markets. Equity markets seem to perk up only when central banks are expanding the money supply. And banking systems are incredibly reliant on implicit or explicit government support.

Banks first. They exist to channel funds from savers to borrowers, traditionally from the household sector to companies. But modern banks raise funds not just from retail deposits, but also from the markets. Until 2007, European banks were able to borrow more cheaply from the markets than the better corporate borrowers (those rated investment grade). But for the past five years banks' borrowing costs have been consistently higher than those of non-



financial firms (see chart). This raises huge question-marks over the banks' role as intermediaries.

These funding pressures have been relieved by massive amounts of liquidity from central banks, most recently through the European Central Bank's long-term refinancing operation. The effect is that private-sector funding has been replaced with official lending.

Central banks have been "lenders of last resort" for banks since the mid-19th century. But these were generally short-term loans made at moments of panic. The ECB has lent a staggering €1 trillion (\$1.3 trillion) on a three-year basis. The hope is that these loans can be refinanced via the private sector in 2014 or 2015. That may be too sanguine. The funding woes of banks are already almost five years old.

Loans from the official sector are being used to reduce the impact of private-sector capital flight. Matt King of Citigroup estimates that €100 billion of capital left Spain in 2011, and €160 billion left Italy, largely as foreigners withdrew bank deposits or sold government bonds. European cross-border capital flows are cleared through the ECB. The net effect is that several countries are substantial debtors of the ECB, while Germany, Finland and Luxembourg are net creditors.

The bond market has never been fully free of central-bank influence: expectations about the future level of short-term rates have always influenced yields. But the Federal Reserve has said that it will keep rates at current low levels until late 2014, an unprecedented commitment. Central banks have been putting downward pressure on yields through quantitative easing (QE) programmes. These are substantial: the Bank of England owns almost a third of the gilt market. The effect is that yields are not set solely by the balance of supply and private-sector demand.

Nor is this the only rigged market. Many countries are following policies that are explicitly (or implicitly) designed to drive the value of their currencies down. And the authorities are helping to prop up share

prices: Ben Bernanke, chairman of the Fed, has welcomed a higher stockmarket as a side-effect of QE.

As a result it is difficult to say what message the markets are sending. Do low bond yields show that investors are endorsing Britain's deficit-reduction programme, for example? Or do they mean that the government has plenty of room to ease fiscal policy and borrow more? Thanks to QE, it is hard to be sure.

Banks have also been big buyers of government bonds in the past couple of years because of the "carry trade": they can borrow money from the central banks at low rates and lend it back to their domestic governments at a higher yield. In effect, this is a disguised subsidy to the banking sector. Banks may buy even more government bonds in future because international regulations assign a low capital charge to government debt and because banks will be required to hold a store of liquid assets, of which bonds will be a big part.

So the government stands behind the banking system, and in turn the banks are big buyers of government debt. This financial-political complex is reinforced by the general unwillingness of governments to let banks go bust. Better to intervene so heavily in markets, the argument runs, than do nothing and repeat the mistake of the Depression.

Maybe. But history suggests that once governments get involved in a sector, they find it hard to withdraw. Given the weak outlook, it is hard to imagine the circumstances in which liquidity support for the banks will be withdrawn, or the policy of low interest rates abandoned. This is a new financial and economic era.

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