

European Central Bank cuts rates and pours more money into financial markets

By Nick Beams
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The European Central Bank (ECB) yesterday unleashed a new series of measures under its quantitative easing program, including expanded purchases of financial assets, a further lowering of interest rates and increased financing for banks. The moves amount to an increasingly desperate bid to counter the worsening outlook for the euro zone and the global economy.

The ECB reduced its deposit rate to minus 0.4 percent from minus 0.3 percent and increased its purchases of financial assets from the present level of €60 billion per month to €80 billion and included for the first time the purchase of debt issued by non-financial corporations. Previously the program, which is set to run to March 2017 or beyond if considered necessary, had only included government debt.

It also decided to extend further credit to banks under its so-called longer-term refinancing operations, charging them interest rates as low as minus 0.4 percent—in effect paying them to borrow money.

However, the immediate effect of the measures was the opposite of what was intended. European markets initially rose on the news because the expansion of the asset-purchasing program by €20 billion was larger than had been expected, but then ended the day sharply down. The euro at first fell against the dollar but then rose rapidly in one of the largest one-day swings in the currency's history. On Wall Street the Dow fell by as much as 178 points before rising to finish the day just 5 points down.

The cause of the gyrations in the currency and equity markets appears to have been remarks by ECB president Mario Draghi that there would be no further interest rate cuts. He said that while interest rates will “stay low, very low, for a long period of time ... we don't anticipate that it will be necessary to reduce rates further.”

He indicated the central bank could not go negative as far as it wanted without any consequences for the banking

system. Since the move by the Bank of Japan to negative rates at the end of January and the spread of the negative-rate regime to countries comprising around a quarter of global gross domestic product, there has been considerable concern that it has having an adverse impact on the business models of banks, leading to significant falls in their share values.

In his prepared remarks Draghi gave a downbeat assessment of the euro zone economy. Real GDP growth was 0.3 percent for the fourth quarter in 2015. While it was supported by domestic demand, it was “dampened by a negative contribution from net exports” with the most recent surveys pointing to “weaker than expected growth momentum at the beginning of the year.”

His assessment on the immediate outlook was internally contradictory. He began by saying that the ECB expected “economic recovery to proceed at a moderate pace”—the standard mantra of all the global financial institutions even as a world economic outlook worsens.

“However,” he continued, “the economic recovery in the euro area continues to be dampened by subdued growth prospects in emerging markets, volatile financial markets, the necessary balance sheet adjustments in a number of sectors [the need to reduce high level of non-performing loans held by European banks] and the sluggish pace of implementation of structural reforms.”

The latter point is a reference to the long-held ECB demand that so-called labour market flexibility—the gutting of conditions of employment—must be intensified throughout the euro area.

Overall “the risks in the euro area remained tilted to the downside” relating to “heightened uncertainties in the global economy as well as geopolitical risks” with the ECB having revised down its estimates for growth from its December meeting.

The official rationale for the program of monetary stimulus is to bring the euro zone rate of inflation towards

but not above the level of 2 percent. However, prices are moving in the opposite direction. The inflation rate for February was minus 0.2 percent, compared to 0.3 percent in January and would only reach 0.1 percent for 2016 as a whole, according to the ECB's own forecast.

During the question and answer session, Draghi sought to answer criticism that the central bank's policy was ineffective and it had had "no ammunition left." He claimed the new range of measures was "very significant" and it was foolish to think it was possible to get back to 2 percent with an economy that had not recovered. But once there was a solid recovery for the euro area there would be an upward movement on wages and prices.

The claim that the program of the ECB and other central banks will eventually bring about a recovery has been thoroughly exposed by economic reality. It is now more than seven years since the meltdown of 2008 and euro zone output has still yet to reach the levels it attained before the financial crisis.

Further remarks by Draghi pointed to the real nature of the so-called "unconventional measures" adopted by financial authorities. "Suppose we had not acted at all? ... What would be the counterfactual? And of course we deem that the counterfactual would have been a disastrous deflation," he said.

In other words, the actions of the ECB are not a program aimed at real economic recovery—their most significant effect has been to increase financial wealth and widen social inequality—but amount to a holding operation to prop up the financial system and prevent a collapse like that of the 1930s. Moreover, the fact that the program has had to be continually widened, signifies that, not only are the underlying contradictions within the financial system still unresolved, they are intensifying.

On the eve of the ECB meeting, Bank of America chief investment strategist Michael Hartnett noted that the policies of central banks over the past seven years had not stimulated economic growth.

"The 'seven-year glitch' is that the underlying narrative of markets remains deflationary, despite 619 global interest rate cuts, \$10.4 trillion of financial asset purchases by central banks, \$9 trillion of global government debt yielding 0 percent—roughly equal to 23 percent of all government debt in the world," he said. There was no sign of monetary stimulus bring an acceleration in GDP "any time soon."

While the latest measures will do nothing to boost real economic growth, they will have an impact. Despite

Draghi's strenuous avowals to the contrary, they represent a stepping up of the currency wars in which countries try to improve their position in global markets by lowering the value of their own currency at the expense of their rivals.

In attempt to head off such criticism, Draghi pointed to the recent G-20 meeting in Shanghai where "all countries took a solemn agreement that basically they would avoid such war" but then acknowledged that some of the latest measures would have a "spillover on the foreign exchange market."

The other major impact will be on the bond markets. Further asset purchases will increase the price of bonds and lower yields (the two move in an inverse relationship), in some cases into negative territory. This means that investment in bonds is not carried out to secure income from interest payments but with the aim of selling the bond at a still higher price as interest rates fall.

As one analyst pointedly commented, with negative-yielding bonds "you are essentially in prayer mode for the opportunity to sell to essentially a bigger fool."

In other words, while the ECB measures are not going to boost the real economy, they will further contribute to turning bond markets into a giant Ponzi scheme, dependent on the continued inflow of cash, thereby creating the conditions for another financial disaster.

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