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Why central bank intervention should make us more worried

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Move to inject cash into the financial system set markets to new heights of euphoria, as they fail to realize this is a sign that they're 'reaching for straws,' analysts say

It was little more than a bandage applied to a patient in need of surgery. But for investors around the world, Wednesday's moves by the world's major central banks to keep money flowing were enough to trigger euphoria.

In the face of a looming global credit crunch and the failure of European leaders to stem their worsening debt crisis, the central banks' action to inject cash into the financial system sent stocks soaring. The euro, Canadian dollar and other currencies climbed against the U.S. dollar, while oil, gold and other commodities rallied as investors decided it was safe to take riskier bets again.

The co-ordinated response by the central banks of the United States, Canada, the United Kingdom, Japan, Switzerland and Europe to dangerous stresses building in the global system was a return to the crippling credit crisis of 2008, when monetary officials also joined forces to thaw frozen credit markets.

But giddiness over the intervention is likely to give way to a more sober reflection. If anything, the central bank moves - along with a surprise Chinese decision to reduce bank reserve requirements - plainly signal that the situation has gone from bad to worse.

The debt woes of a handful of fiscally challenged euro-zone governments have spread far beyond their regional confines to infect major banks in Europe. As investors and depositors have moved money out of euros, it becomes more difficult for their banks to find the money to make loans and keep the continent's economy growing.

"We're now seeing that solutions haven't been working and they're reaching for straws," said Alex Jurshevski, managing partner of Recovery Partners, an expert on debt restructuring. "These are just patch moves. They're not long-term solutions for anything because what you have in Europe right now is a broken funding model. What you have is a currency that no one wants to be in any more."

To be sure, the central banks' moves may be essential to prevent another financial freeze of the type that brought the global economy to its knees three years ago.

The action enables European banks, which have been all but shut out of many normal channels for borrowing short-term money, to gain access to badly needed U.S. dollars at reduced interest rates. This is essential because a great deal of the world's economic activity is financed in the U.S. currency.

The central banks also set up innovative arrangements to distribute each other's currencies to their own banks, while stressing that this is only in the event of a future emergency.

But none of this will do anything to bring down borrowing costs for Italy, Spain or other debt-laden euro-zone governments to manageable levels. Italy's financing costs remain sky high - with 10-year bond yields at 6.98 per cent.

"The Italians are unfundable," Mr. Jurshevski said. "They might be able to raise money at 7 per cent, but the reality is their economy doesn't work with funding rates north of 4.5 per cent."
The Center for Economic and Policy Research in Washington added that "until there is central-bank intervention to lower these interest rates, and to keep them down, the current financial crisis in Europe will not be resolved."

And it's still not clear whether euro-zone leaders have a plan to bring long-term stability. European finance ministers revealed vague plans Tuesday to strengthen the bailout fund known as the European Financial Stability Fund, which is meant to aid the countries in the worst shape. But they failed to show they have enough money lined up to prop up those debt-strapped governments. Wednesday's central-bank intervention does little to change that reality.

As European leaders dither, investors are bound to soon turn sour again. And an otherwise solvent Italy and Spain will move inexorably closer to a painful and messy debt restructuring. The only way to prevent this, safeguard the euro and contain the damage to the global financial system is to hand the European Central Bank a mandate for unlimited intervention, replace the unloved debt of Italy, Greece, Spain *et al* with euro-wide bonds or guarantees from the strongest governments and get to work on real fiscal reform.

Until we see clear signs that the Germans and other key European political leaders are prepared to step out and embrace some of these more radical measures, it should come as no surprise that mistrust among banks is growing - or that corporations, governments and their central banks are preparing contingency plans for the eventual demise of the currency union.