European Central Bank bond-buying program fuels financial turbulence

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The president of the European Central Bank, Mario Draghi, has strongly defended the bank's bond-purchasing program, which began on Monday and is set to inject at least €1 trillion into the financial system over the course of the next 16 months.

Speaking at a conference of economists and financial analysts in Frankfurt yesterday, Draghi said the benefits of the program were filtering down to consumers and businesses and were protecting the rest of the euro zone from the turmoil in Greece.

"Developments are pointing in the right direction," he said.

While he acknowledged that there were some risks in the policy, because it lowers the yield on government bonds and pushes investors to undertake riskier actions, he claimed these dangers were "contained."

Draghi tried to downplay the significance of the ECB's move, saying that while asset purchases were "unconventional," they were not "unorthodox," adding, "In fact, they are eminently orthodox."

The assertion must have been made for wider public consumption, for the purpose of offering some sort of reassurance, because everyone in the audience was well aware that nothing like the asset purchasing program of the world's major central banks, which has pumped at least $5 trillion into the global financial system, has ever been seen in history.

On the first day of the program, the ECB bought €3.4 billion worth of bonds in line with its objective of buying €60 billion a month at least until September next year, and possibly even longer, because officially the ECB has "no duration target for the program."

Within days of its commencement, the purchasing program is having a significant impact on financial markets, setting up a series of processes that could have major adverse consequences, contrary to Draghi's reassurances.

One of the most striking effects so far is the rapid fall in the value of the euro against the US dollar. This year, the value of the euro has dropped 12.8 percent, already beating the 10.6 percent decline recorded in the third quarter of 2008, in the midst of the global financial crisis.

It is expected to fall even lower as the bond-purchasing program proceeds, with predictions that the euro is headed for parity with the US dollar after falling to just over $1.05 yesterday.

The other major consequence is the further fall in yields on bonds, as their prices are pushed higher as a result of the entry of the ECB into the market. The yield on the benchmark ten-year German bund fell to 0.199 percent after starting the year at 0.5 percent. The spread between it and the equivalent ten-year US Treasury bond is the largest in 25 years. The yield on German five-year bonds fell to a record low of minus 0.125 percent compared to the yield on equivalent US treasuries of 1.6 percent.

The yield on French ten-year bonds also went below 0.5 percent, and yields on government debt in Spain, Italy, Finland and Austria also fell to record lows.

According to Draghi, by lowering interest rates, the asset-purchasing program will create the conditions for a revival of business investment in the real economy. In fact, the ECB's intervention is financing massive speculation, in which investors figure that even though the prices at which they purchase bonds are at record highs (with yields correspondingly at record lows), they will be able to make money through capital gains by selling the bonds they have purchased at even higher prices.

The ECB program is pushing the US dollar higher against all major global currencies. There are growing concerns that the higher dollar is worsening the international competitive position of US corporations and impacting their bottom line.

These profit concerns appear to be behind the recent falls on Wall Street, coupled with fear that an ostensibly favourable US jobs report last Friday will encourage the Fed to begin lifting official interest rates from their current record low level of 0.25 percent. It is a sign of the way in which the financial markets have entered a "through the looking glass world" that what should be a sign of an improving real economy gives rise to a stock market fall.

The rise in the dollar's value has reignited fears that so-called emerging markets could face financial problems because the more expensive dollar increases the real debt and interest burden by dollar-denominated loans. In 2013, emerging market currencies fell sharply following indications by the US Federal Reserve that it was going to wind down its asset-purchasing program. Now there are signs that the "taper tantrum" could be repeated.

Last week, the JPMorgan Emerging Market Currency index fell to a record low after the release of the latest US jobs data. A JPMorgan analyst told the *Financial Times* that divergences in monetary policy between the US and emerging economies would become more relevant in the months ahead. If the Fed lifts interest rates, the money that has flowed into emerging markets over the past two years could rush for the exit.

Last week, both the Turkish lira and the Mexican peso fell to record lows against the US dollar. The Brazilian real is down to a ten-and-a-half-year low against the dollar, while the South African rand is approaching its lowest point in 14 years. The Indonesian rupiah is trading at levels last seen in the Asian financial crisis of 1997-98.

All these trends will be reinforced by the ECB's asset-purchasing program. There are also growing risks for major European financial institutions, which were highlighted in an article by *Financial Times* columnist Wolfgang Münchau on Monday, in which he pointed to its implications for the life insurance industry.

The life insurance business model is based on selling products and annuities and then investing the money received from policyholders in government and corporate bonds on the assumption that the average return on the bonds they hold is higher than the rate at which they pay out. However, at zero rates, "it is very difficult for the industry as a whole to remain solvent."

Münchau cited simulations conducted by staff at the German Bundesbank which showed that if interest rates stayed low for a long time, then, in one scenario, 12 of 85 German insurance companies could be insolvent by 2023, and in another, harsher scenario, the number would rise to 32 companies. In addition, under-funded pension schemes run by many German companies would be in trouble.

The precise course of events is impossible to predict, but the findings are significant from a broader perspective. The activities of life insurance companies, pension funds and other long-term financial investors, seeking steady, low-risk returns, have provided a basis for the financial system for many decades. But now these foundations are being blown up by the very central banks that are supposedly responsible for the maintenance of stability. It is as if pyromaniacs had been put in charge of the fire department.