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Subject:

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"Last month, in a surprise move, Euro zone banks were given immense backing from their Central Bank (the ECB) via a lending program that supports them with three year money. The ECB and the Federal Reserve, despite different mandates, appear aligned and committed to do all they can to find a cure for what ails us. Between our Fed's QE2 and twist and the ECB's program backed by various types of collateral (even shorter term), the stage is set for an unprecedented expansive push to get the world going.

While these Central Banks may have selected the only approaches available to address respective regional needs, recent actions are but the first steps on technically challenging paths that require dexterity and substantial follow through by government policy makers to avoid major pitfalls and ensure long term success. With awe inspiring fiscal deficits on both sides of the Atlantic, the Fed and ECB pursue strategies that can result in a potentially dangerous mix if governments lose discipline and fail to address budgets and debt levels in due course.

A frequent visitor to Germany, I hear three things when it comes to the Euro zone crisis: First and foremost, there is a respect for and sense of accountability to all of Europe. Second is the belief that individual countries must control their budgets. And third, there is the conviction that the European Central Bank cannot be allowed to print money to lend to sovereign governments.

Many Germans are terrified of runaway inflation because of what it did to their country in the first half of the last century. Runaway inflation is a crushing, relentless burden on society's most fragile. And it is set in motion at times when governments print money to avoid difficult fiscal choices. I am very sympathetic to these concerns because of my personal experience in the 1980s, living in Brazil and witnessing inflation's corrosive effect on that nation.

It's said that the values of America's greatest generation were forged by the deprivations they observed and suffered during the Great Depression. Brazilians in their 30s and older vividly recall what it was like to live through an inflationary economic catastrophe caused by heavy handed planners and government led profligacy.

Extraordinary yet understandable are the generations presently building Brazil (even their recent, leftist, Presidents), who for the most part support fiscal and monetary views that our great grandparents and today's conservative Germans would likely endorse.

Governments often avoid difficult choices. And with all that's gone on in the past few years, it is amazing we can still find comfort in the assumption that, at crunch time, the right people will be imbued with the necessary special perception and deftness to hit all the correct buttons so everything works out just so.

The Federal Reserve purchased over \$2 trillion dollars of US debt during the past couple of years. Where does this money come from? And now, the Europeans are doing something similar to finance local banks and their demand for Euro zone sovereign debt.

A week ago, the ECB ran its first auction of three year bank funding. More than 500 local banks borrowed US\$635 billion in a single day. Although a portion of this financing replaced existing short-term funding, my guess is that, unchecked, ECB leveraging will grow significantly in the coming months. Both Central Banks have already multiplied the size of their balance sheets to record levels to get money to the public markets. At some point, there will have to be a change or there will be consequences.

Paul Krugman once said: “Unsustainable situations usually go on longer than most economists think possible. But they always end, and when they do, it’s often painful.”

With the ECB liquidity actions and the Fed’s push for growth by boosting demand, somewhere down the road Central Bank heads will be called on to demonstrate that they can be “Masters of the Universe”. To be successful, they will need to act with uncanny precision, independence and self-control to manage this unprecedented monetary expansion and avoid painful, unintended consequences.

Low bond rates and continued fiscal deficits are a fragile equilibrium, however. And, in the face of challenges like supply shocks or major sovereign downgrades, there will be trade-offs and potential for mistakes.

The Fed and ECB have stepped up big time. However, to achieve sustainable growth, they, and the rest of us, rely on government policy makers to follow through, abandon learned helplessness and take action on the trajectory of spending, government efficiency and reasonable tax policy.

It’s a huge bet with an uncertain outcome. We are rooting for success. But as officials grasp more levers to operate the world’s complex financial machinery, we can only hope that these managers and technicians do not overlook that homespun yet universal economic truth: there is no such thing as a free lunch.

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