

The  
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## Economic policy

# A world of cheap money

### The Federal Reserve is making a better job of it than the European Central Bank

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THE low-rate world was not meant to last. In 2008-09, when central banks slashed short-term rates close to zero and started buying bonds to push down longer-term rates, everyone assumed these extraordinary measures would soon be unwound as economies recovered.

But the extraordinary has become the norm. America's Federal Reserve is still printing money to buy bonds and has made it clear that it will not raise short-term rates at least until unemployment, now close to 8%, falls to 6.5%. At the Bank of Japan Haruhiko Kuroda, the new governor appointed by the stimulus-minded prime minister, Shinzo Abe, this week announced a new phase of monetary easing to hit an inflation target of 2%: bond purchases will be stepped up to double the country's monetary base. The Bank of England's mandate has been tweaked to allow rates to stay lower longer. Even the European Central Bank (ECB) may be inching towards greater boldness. The message from the rich world's central banks is clear: the era of ultra-loose monetary policy is here to stay.

That has had a huge effect on financial markets. Japan's Nikkei index is up by 40% since Mr Abe promised bold stimulus in November. America's S&P 500 index and the Dow Jones industrial average are both at record levels. Frothiness is back as investors search for higher returns, whether in junk bonds, African government debt or the new "structured credit" products dreamt up by the

same investment banks that sliced up mortgages in the bubble years (see [article](http://www.economist.com/news/briefing/21575773-central-banks-have-cushioned-developed-worlds-economy-difficult-period-they-have-yet) (<http://www.economist.com/news/briefing/21575773-central-banks-have-cushioned-developed-worlds-economy-difficult-period-they-have-yet>)).

Unfortunately, the effect on output has been more muted. America's GDP is showing signs of accelerating. But Europe's economies are flat or shrinking. Overall, rich-world growth is likely to be barely over 1% in 2013, little better than in 2012.

**Given the gap between financial froth and feeble growth, are central bankers doing the right thing?**

Supporters argue that cheap money is essential for economic recovery, particularly when (as in Europe and America) austerity-minded governments are tightening fiscal policy. Critics counter that low rates simply pump up asset bubbles, distort financial markets and risk inflation. *The Economist* is a supporter—but cheap money will work only if the medicine is administered properly and if governments change other things, too.

The critics are right that cheap money has clearly had its biggest effect in finance, but its effect on other parts of the economy has not been as negligible as they suggest—especially in America, where **households have responded to lower borrowing costs**. House prices have been rising, the pace of mortgage origination is 40% higher than a year ago and consumer credit is growing: the pace of new car loans is at a six-year high.

The link that has proved most elusive is between cheap money and corporate investment. Firms have taken advantage of the low rates to issue new debt, but they have used the cash to refinance loans or build up rainy-day funds. That may make sense for the firms concerned, but it provides a smaller boost to growth than building new factories. Businesses are still sitting on record piles of cash (\$1.8 trillion in America's listed firms alone). High share prices and low borrowing costs should eventually awaken bosses' animal spirits. In America capital spending is accelerating. In Europe the prospects are gloomy, not only because of worries about the euro and growth but also because cheap money is regional: according to Goldman Sachs, rates for business loans in southern Europe are nearly four percentage points higher than in the north.

How to make it work

That transatlantic gulf underlines the point of cheap money. It can help, but only if it is applied appropriately and with other remedies. Europe can learn from America in three ways.

First, boldness pays. It is no accident that the most aggressive central bank (the Fed) has seen the biggest impact on spending by households and firms—nor that the most timid central bank (the

ECB) has seen the weakest growth.

Second, not all unconventional policies are equal. The Bank of England's focus on buying government bonds helped households less than the Fed's purchases of mortgage-backed bonds. Central banks should put their money where the problem is. In the euro area, that means reducing borrowing costs for firms in the crisis countries of the periphery.

Third, and most important, monetary policy does not operate in a vacuum. If you simultaneously tighten fiscal policy (as Europe has done and America is now starting to do), it will soften the effect of cheap money. America has also restructured its banks far faster than Europe has, and its economy is less tightly regulated. It could certainly still use cheap money better—for instance, by boosting public investment in infrastructure, as Britain should too. But the Fed's creativity has raised the odds of the experiment working. In Europe the combination of a timid ECB, harsh austerity and minimal structural reforms is not giving growth much of a chance.

From the print edition: Leaders