Central bank prophet fears QE warfare pushing world financial system out of control

Former BIS chief economist warns that QE in Europe is doomed to failure and may draw the region into deeper difficulties

By Ambrose Evans-Pritchard, in Davos

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The economic prophet who foresaw the Lehman crisis with uncanny accuracy is even more worried about the world's financial system going into 2015.

Beggar-thy-neighbour devaluations are spreading to every region. All the major central banks are stoking asset bubbles deliberately to put off the day of reckoning. This time emerging markets have been drawn into the quagmire as well, corrupted by the leakage from quantitative easing (QE) in the West.

"We are in a world that is dangerously unanchored," said William White, the Swiss-based chairman of the OECD's Review Committee. "We're seeing true currency wars and everybody is doing it, and I have no idea where this is going to end."

Mr White is a former chief economist to the Bank for International Settlements - the bank of central banks - and currently an advisor to German Chancellor Angela Merkel.

He said the global elastic has been stretched even further than it was in 2008 on the eve of the Great Recession. The excesses have reached almost every corner of the globe, and combined public/private debt is 20pc of GDP higher today. "We are holding a tiger by the tail," he said.

He warned that QE in Europe is doomed to failure at this late stage and may instead draw the region into deeper difficulties. "Sovereign bond yields haven't been so low since the 'Black Plague': how much more bang can you get for your buck?" he told The Telegraph before the **World Economic Forum in Davos**.

"QE is not going to help at all. Europe has far greater reliance than the US on small and medium-sized companies (SMEs) and they get their money from banks, not from the bond market," he said.

"Even after the stress tests the banks are still in 'hunkering down mode'. They are not lending to small firms for a variety of reasons. The interest rate differential is still going up," he said.

The warnings come just as the European Central Bank prepares a blitz of bond purchases at a crucial meeting on Thursday. Most ECB-watchers expect QE of around €500bn now that the eurozone is already in deflation. Even the Bundesbank is struggling to come with fresh reasons to oppose it.

The psychological potency of this largesse will depend on whether the ECB opts for shock-and-awe concentration or trickles out the stimulus slowly. It also depends on the exact mechanism used to conduct QE, a loose term at best.

ECB president Mario Draghi hopes that bond purchases will push money out into the broader economy through a "wealth effect", but critics fear this will be worse than useless if it leads to an asset bubble without gaining traction on the real economy. Classic moneratists say the ECB may end up spinning its wheels should it merely try to expand the money base.

Mr White said QE is a disguised form of competitive devaluation. "The Japanese are now doing it as well but nobody can complain because the US started it," he said.

"There is a significant risk that this is going to end badly because the Bank of Japan is funding 40pc of all government spending. This could end in high inflation, perhaps even hyperinflation.

"The emerging markets got on the bandwagon by resisting upward pressure on their currencies and building up enormous foreign exchange reserves. The wrinkle this time is that corporations in these countries - especially in Asia and Latin America - have borrowed $6 trillion in US dollars, often through offshore centres. That is going to create a huge currency mismatch problem as US rates rise and the dollar goes back up."

Mr White's warnings are ominous. He acquired great authority in his long years at the BIS arguing that global central banks were falling into a trap by holding real rates too low in the 1990s, effectively stealing growth from the future through "intertemporal" effects.

He argues that this created a treacherous dynamic. The authorities kept having to push rates lower with the trough of each cycle, building up ever greater imbalances, in an ineluctable descent to the "zero bound", where monetary levers stop working properly.

Under his guidance, the BIS annual reports over the three years before the Lehman crisis were a rising crescendo of alarm calls at a time when other global watchdogs were asleep. His legendary report in June 2008 openly discussed whether the world was on the cusp of events that might prove as dangerous and intractable as the Great Depression, as it indeed it was.

Mr White said central banks have been put in an invidious position, compelled to respond to a deep economic disorder that is beyond their power. The latest victim is the Swiss National Bank, which was effectively crushed last week by greater global forces as it tried to repel safe-haven flows into the franc. The SNB was damned whatever it tried to do. "The only choice they had was to take a blow to the left cheek, or to the right cheek," he said.

He deplores the rush to QE as an "unthinking fashion". Those who argue that the US and the UK are growing faster than Europe because they carried out QE early are confusing "correlation with causality". The Anglo-Saxon pioneers have yet to pay the price. "It ain't over until the fat lady sings. There are serious side-effects building up and we don't know what will happen when they try to reverse what they have done."

The painful irony is that central banks may have brought about exactly what they most feared by trying to keep growth buoyant at all costs, he argues, and not allowing productivity gains to drive down prices gently as occurred in episodes of the 19th century. "They have created so much debt that they may have turned a good deflation into a bad deflation after all."