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The Fed's regimen will not remedy Europe's ills

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Once again, these are gloomy days for the eurozone. The yield on German 10-year government debt dipped below 1 per cent for the first time last week, signalling that investors expect growth to remain anaemic and leading to calls for the European Central Bank to start a full-blown quantitative easing programme, buying government bonds.

This is the path the US Federal Reserve took in 2008. But it would be a mistake for the ECB to follow. Bond yields are already at record lows; reducing them further is unlikely to stimulate investment in an economy that, unlike America's, is still funded largely through the banking system rather than the bond markets. Some argue that quantitative easing would weaken the euro. This would be welcome, but it will not happen while the Fed stays on its present path.

There are times when aggressive monetary policy makes a difference. This is the lesson that Ben Bernanke, the former Fed chairman, taught the world's central bankers in the aftermath of the financial crisis. But Europe's biggest problems are structural, and QE will not fix them.

The German economy, at least, is still fundamentally strong. The contraction in the second quarter reflects a normalisation following the previous quarter, when construction activity during a mild winter fuelled annualised growth of 3.6 per cent. Longer-term, the outlook for Germany will deteriorate if the government continues with retrograde steps such as lowering the retirement age. But that is another story. The situation has also improved in countries that are emerging from gruelling rescue programmes imposed by the International Monetary Fund and the European Commission. Spain and Portugal posted annualised growth of more than 2 per cent last week. Even Greece is making progress.

The eurozone still has deep problems, however. France and Italy are in a bad way, and no amount of QE can bring them back to growth. Their governments need to reform their labour markets, reduce taxes that weigh on business, free companies from red tape and continue to repair their public finances. Merely talking about such reforms is not enough.

Spain is among the programme countries whose recent experience proves that structural change is possible. Gerhard Schröder, Germany's socialist chancellor between 1998 and 2005, introduced far-reaching labour market reforms that in many ways laid the foundation for the country's recent resilience. But QE would merely enable governments to borrow even more cheaply, giving recalcitrant politicians an easy way out.

That a bond-buying programme is unlikely to succeed is not, however, the reason why it should not be

tried. After all, another lesson from the crisis is that in the face of impending disaster, you should try different approaches until something works. The trouble is that there are costs associated with embarking on aggressive QE in the eurozone. Yet virtually no one is pointing this out.

As the Basel-based Bank for International Settlements has urged, QE would create further distortions in financial markets. Market participants already witness these every day. Certain technology stocks, covenant light loans and government bonds are obvious candidates. Things would surely become worse if the ECB decided to copy the Fed. These distortions will ultimately lead capital to flow into mispriced financial assets, instead of financing investment in new productive capacity. This, in turn, will undermine the proper functioning of the economy, leading in the end to lower potential growth – the opposite of what monetary activism is supposed to achieve.

The ECB should not follow the path of the Fed. But that does not mean that Europe's central bankers are powerless. The key is to mend the ailing European banking system. There will be no robust European growth without properly capitalised European banks. It is certainly possible that targeted asset purchases could play a role in reinvigorating the eurozone banking system if they succeed in reducing real interest rates for companies and households. But they cannot achieve this result on their own. Banks can now borrow money much more cheaply than in July 2012, but they have not passed the benefits on to customers – either by lending more, or charging lower interest rates.

Mario Draghi is right to prioritise fixing the banks. That can happen only if the ECB president continues to focus all his energy on the comprehensive assessment of eurozone banks. Swift action is essential to rectify any capital shortfalls that are discovered.

The Fed's bond-buying programme appears to have contributed to the recovery of the US economy. But Europe's growth problems are different. They lie in the structural ills of the French and Italian economies, and the continuing ill health of the eurozone's banks.

No amount of QE will cure this malaise. Europe needs its own ideas. It cannot simply copy the Fed.