The Telegraph

Deflation danger over for European Central Bank but fresh debt drama looms

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3 APRIL 2017 • 7:58PM

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Eurozone unemployment has dropped to an eight-year low of 9.5pc, but is still painfully high. Two-fifths of young Spaniards still jobless

The European Central Bank has declared victory over deflation in a watershed shift in policy, clearing the way for an end to negative rates and emergency bond purchases after years of deep economic malaise.

Triple tail-winds from QE, a cheap euro, and the end of fiscal austerity have all combined with powerful effect, at last lifting the economy out of a low-growth trap, or 'Lost Decade' as some economists describe it.

A blizzard of new figures paint a picture of accelerating growth across the region, with with unemployment falling to an eight-year low of 9.5pc - though it is still twice the level of the Anglo-Saxon and non-euro Nordic states. The eurozone's jobless rolls have dropped by 1.24 million over the last year.

“Since the crisis we have had serious concerns about deflationary risks on several occasions in the euro area, but now we can say they have disappeared,” said Peter Praet, the ECB’s chief economist.

Peter Praet, chief economist at the European Central Bank

The comments are significant since Mr Praet has long been viewed as an arch-dove on the ECB’s executive council. Analysts at Citigroup say that German-led hawks in Frankfurt appear to be gaining the upper hand in their fight against quantitative easing (QE), raising the risk of a tightening signal over the next two policy meetings.

Mr Praet said last year’s blast of stimulus by G20 authorities in response to the Chinese currency panic had averted a worldwide downturn and was now feeding through into full-blown recovery. “This coordinated reaction was very effective,” he told the Spanish newspaper Expansion.

What is not yet clear is whether the eurozone is entering a virtuous circle - driven by rising investment - or whether the current cyclical recovery is largely a sugar rush that will fade as stimulus is withdrawn.

To the extent that reflation and recovery gather force, they create a whole new set of risks for the eurozone since nobody knows what will happen to Italy, Portugal, and other high-debt states when the ECB stops buying their sovereign bonds.

The ECB is to cut its monthly bond purchases from €80bn to €60bn this April, a move seen as “tapering” by investors. David Owen from Jefferies said the ECB is already buying $160m less of Italian debt every day as a result.

Markets are afraid that the governing council could sketch out a hawkish timetable for monetary tightening at any meeting over coming months.

Mario Draghi, head of the European Central Bank

Athanasios Vamvakidis from Bank of America said the ECB will have to act as a reflation gathers force, and as it does this will rip away the protective shield for the weakest states.

“ECB support cannot last long and a number of indicators raise red flags to us in relation to the periphery’s vulnerabilities in the years after QE. It is a matter of time when markets will start questioning the sustainability of the eurozone again,” he said.

The tensions are already evident in bond auctions. The yield spread on Italian 10-year debt over German Bunds has doubled to 203 basis points since early last year, a foretaste of what could happen once the country faces the chilly reality of the markets again.

A report by Mediobanca said the ECB covered Italy’s entire budget deficit last year and financed the roll-over of existing bonds. "Tapering will leave the Italy without the key buyer of its debt. The debate regarding a unilateral exit from the eurozone and a return to the lira looks likely to gain momentum,” it said.

Bank of America said the public debt ratios of Italy, Spain, Portugal, Cyprus, and Greece, are all higher than they were at the onset of the debt crisis in 2012. Their central banks today also owe more to the ECB through the internal Target2 payments system than they did at the worst moments of that episode. “Our economists our particularly concerned about Italy,” it said.

The bank said there is still yawning gap in competitiveness between Germany and southern Europe. The periphery has clawed back some ground through internal devaluations but these gains have gone into reverse since 2015. Above all, Germany’s exchange rate remains 15pc undervalued, yet the country refuses to take any serious steps to narrow the gap by stimulating internal demand.

Greece and other southern Eurozone nations remain a flashpoint for the ECB and other international bodies which have bankrolled it, like the IMF

As ever, the root problem is the unfinished structure of EMU. The currency still lacks a fiscal union, eurobonds, and counter-cyclical transfers needed to make it viable over time.

A group of leading economists and thinkers for the Jacques Delors Institute warned in a seminal report last year that EMU states will have to accept a supra-national system with a pooling of debts - anathema to the creditor bloc of Germany, Finland, Holland and Austria.