5 December 2011

ECB Holds the Key to a Tentative Equilibrium

- **The ECB has two vital decisions to make this week.** First in respect of monetary policy for the overall Eurozone economy (Thursday) and second in respect of its interventionary role in the PIIGS bond markets (Thursday and/or Friday).
- **The official interest rate should be brought down to zero immediately with the prospect of unsterilized QE to follow.** The job of any central bank in pursuing a symmetric approach to price stability is to set its official interest rate at the level that reflects the natural clearing rate in the economy. In a world conducive, both structurally and cyclically, to exceptionally low interest rates, the Fed, BOE and BOJ have been guided by "Taylor rule" considerations to first take their rates to zero and to follow through with sustained QE to create a significantly negative effective rate. In a Eurozone economy with unemployment historically high and rising again as recession looms and as markets demand severe fiscal retrenchment over an increasing part of the total, ECB monetary policy looks dangerously out of line. Conventional QE involves a central bank pushing down the "risk-free" bond yield through interventionary purchases. In the Eurozone context, **this would imply significant unsterilized purchases of German and other relatively low-yielding Eurozone bonds.** Intervention (albeit sterilised) to push down the spread on PIIGS bonds is fraught with moral hazard and related financial and political risk, whereas interventionary measures to push down the risk-free rate underneath these spreads is consistent with now conventional monetary policy. We will see on Thursday, just how "Fed-like" the Draghi led ECB is prepared to be in the context of a major and defining crisis.
- **The challenge for Friday's summit outcome is to sufficiently maximise the credibility of likely near term commitment by Eurozone governments to an accelerated drive towards high level fiscal union/enforcement (Maastricht with teeth),** to realistically allow/persuade the ECB to very significantly increase its support for PIIGS bonds markets (whether directly or indirectly) and to convince markets of the EU/ECB resolve to repair fiscal imbalances while supporting bond markets in the meantime. The challenge is also to minimise the need for unpredictable referendums to achieve any related requirements for treaty change. Any Franco/ German lead towards such a union must not be mistaken for drift towards a two-speed Eurozone.
- **Market forces would continue to be the key enforcer of ongoing required retrenchment in any event**. The faceless, apolitical and unrelenting markets have been the most effective and politically acceptable driver of painful retrenchment. Germany's undeclared policy of letting markets push the PIIGS close to but not over the precipice has been both necessary and effective in achieving political change and sustained commitment to austerity. The morally hazardous and politically fraught alternative of open ended unconditional ECB support and/or Eurobonds remains as unlikely and inappropriate as ever.
- **So any achieved equilibrium would inevitably remain tentative** and dependent on ongoing evidence of fundamental retrenchment progress. PIIGS bond spreads would remain high (but nonetheless within the limits of perceived debt sustainability), forcing ongoing deflation/retrenchment. The best we should expect is that the crisis has passed its point of peak neurosis and that spreads will subside gradually over the coming years as retrenchment targets are adhered to.
- **There are nonetheless significant grounds for optimism that stabilisation can be achieved** through such an ECB focused holistic remedy providing some combination of adequate overall monetary easing and sufficiently increased support for PIIGS bond markets. Both are absolutely necessary but the more the ECB does of the former, the less it might have to do of the less palatable latter. Potential for sub-optimisation nonetheless lies in any underestimation by the ECB of the imperative for a sea change in its monetary policy settings.
- **There is scope for Euro weakness if the ECB eases aggressively**. This has always been a sovereign debt crisis within Eurozone rather than a currency crisis for the Euro. So the Euro could go weaker, providing further welcome support for the overall Eurozone economy, if the remedy for the debt crisis includes aggressive monetary easing. With monetary policy now returning to pro growth settings in the BRIC economies, Eurozone exporters to these regions would stand to benefit.

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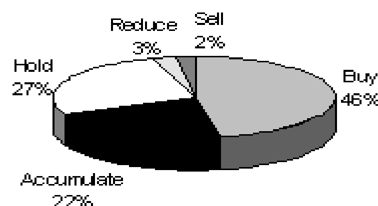

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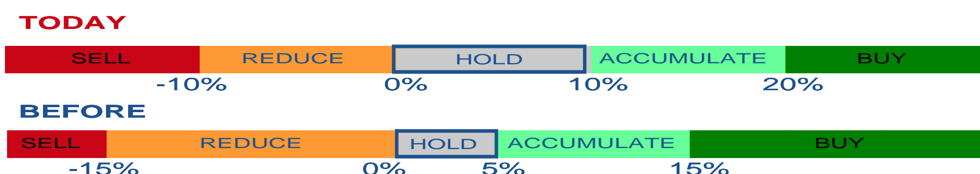

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