

Market Focus

The Earth Starts To Move

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“...some extraordinary things will almost certainly need to happen – probably by late January – to prevent progressive closure of all the euro zone sovereign bond markets, potentially accompanied by escalating (bank) runs.....In the short-run, this cannot be fixed by the ECB or by new governments in Greece, Italy or Spain: it’s about markets needing credible signals on the shape of fiscal and political union long before final treaty changes can take place.” Market Focus 21st November 2011

“One can’t muddle through anymore” Angela Merkel 22nd November 2011

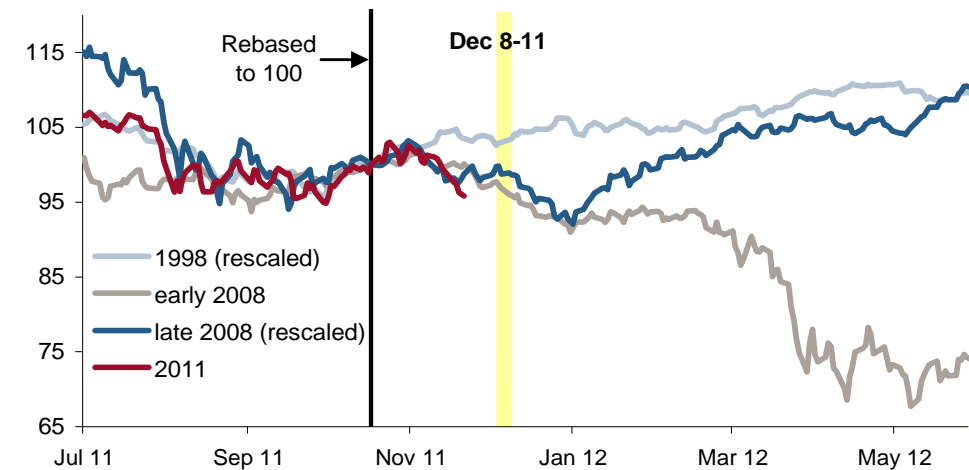
The political earth has started to move in the euro zone. Finally. Over the past week a number of previously unshakeable bargaining positions have started to shift. To get a flavour of just how many, read today’s [Peripheral Watch](#) from our European Economists. (If you don’t subscribe it is *essential* reading).

Most important, politicians are now focusing on how to create a “pre-nuptial” agreement on fiscal union that leads up to fuller treaty changes but does not need to wait for them. This will likely take the form of some deal to make the frequently flouted and toothless Stability Pact rules far more binding under a side agreement between euro zone members that can be put in place very quickly. It would require countries where government debt or deficits exceed the Maastricht criteria to cede key aspects of fiscal sovereignty to a central authority. And would probably be backed up by conditional lending to support new issuance in Spain and Italy from the IMF, and possibly a lightly leveraged EFSF.

Meanwhile, the most senior politicians have generally stopped trying to tell the ECB what to do (a big hint that the ECB is considering responding positively provided there is no taint of it bowing to political pressure). But in any case there is now, or very soon will be, enough justification for the ECB to act within its own mandate in at least two ways. First, to extend long-term funding to the banks (it is already asking the biggest banks whether they would participate in a 2 yr or 3 yr LTRO). And second, to cut interest rates to 1/2% or 3/4% and then do “conventional” QE of say €1 trillion – that is buy sovereign bonds across the board in proportion to GDP/ECB capital shares, as our economists suggest.

The first action goes with its financial stability mandate, the second is fully consistent with its price stability mandate since the euro zone economy is starting to behave exactly like it did post-Lehmans. And ongoing closure of sovereign debt markets, let alone a euro break up, would bring a plague of deflation, depression, downgrades and default to the whole region.

We expect this morning’s bounce in risk appetite to extend further between now and the 8th/9th December, (ECB and European Council meetings) but that does not preclude a renewed sell-off into end-year/early January until the deals are sealed. At which point, virtually all G-20 central banks will be easing, including China, in our view. In short, global reflation, which hopefully really will get the earth moving.

Exhibit 1: World Wealth Crisis Scenarios

Source: Credit Suisse

Deflation Fighter Needed

It's no exaggeration to say that the euro zone is already in the grip of powerful deflationary forces that demand a monetary antidote.

And a pre-emptive one at that.

The euro zone economy is not just sliding into recession: it is starting to behave every bit like it did immediately after Lehmans failed in 2008. The simplest way to document that is to look at the charts of industrial and PMI new orders below. And think of the destabilising consequences for bank and sovereign credit worthiness likely to flow from another "routine" recession, let alone another 2008 – see Exhibit 4.

Nor can there be any real doubt that deflationary forces have started to accelerate in the last few weeks; one only has to look at the escalating recourse to the ECB by euro zone banks, their desperate scramble to shed or repo assets of every sort, and the fact that euro area M3 money supply actually fell in October.

To those who counter that German data show little confirmation of this dire prospect as yet, we would simply point out that by the time they do it will probably be too late to save the system. And from the point of view of short-term prospects for German industrial production (still a very large share of GDP) the fact that production has spiked up very sharply relative to new orders in recent months is a stark warning that German production will soon fall sharply as well.

Moreover, any idea that in the short-run a break up would actually save the day or help prevent depression and deflation (even in Germany itself) are almost certainly wishful thinking. (The argument that break up would be catastrophic for the economy in the short-run is essentially that the payments system would break down – as argued for a long time by our own William Porter and succinctly summarized by Professor Barry Eichengreen in 2010 – link and excerpt in appendix at the end).

For all intents and purposes we are experiencing something even more dangerous than Lehmans or a standard bank run, since the run is progressively extending to the sovereign themselves who would normally guarantee the banks.

Exhibit 2: Euro Area Industrial Production and New Orders

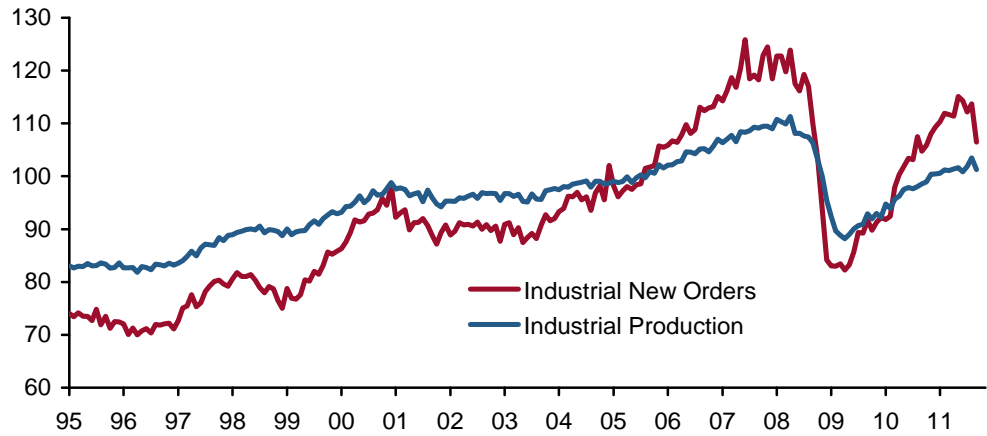


Exhibit 3: Euro Area PMI New Orders and Industrial New Orders Momentum

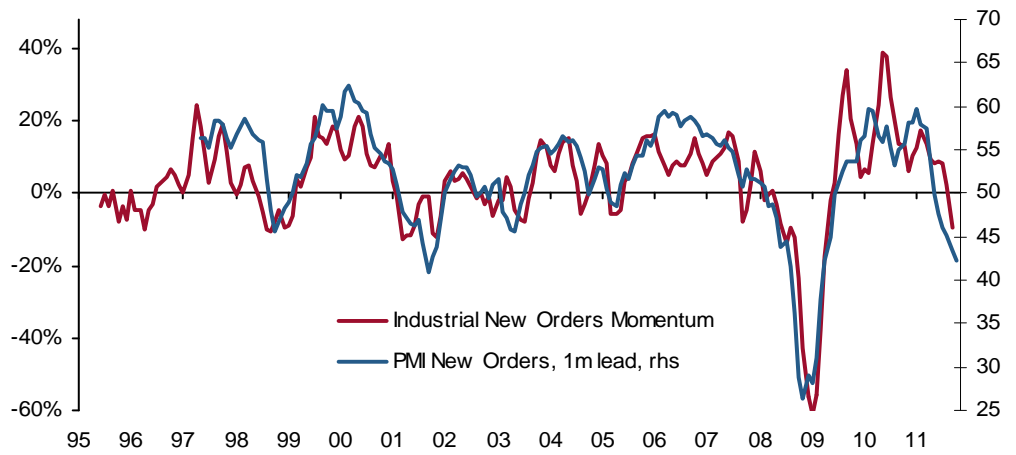
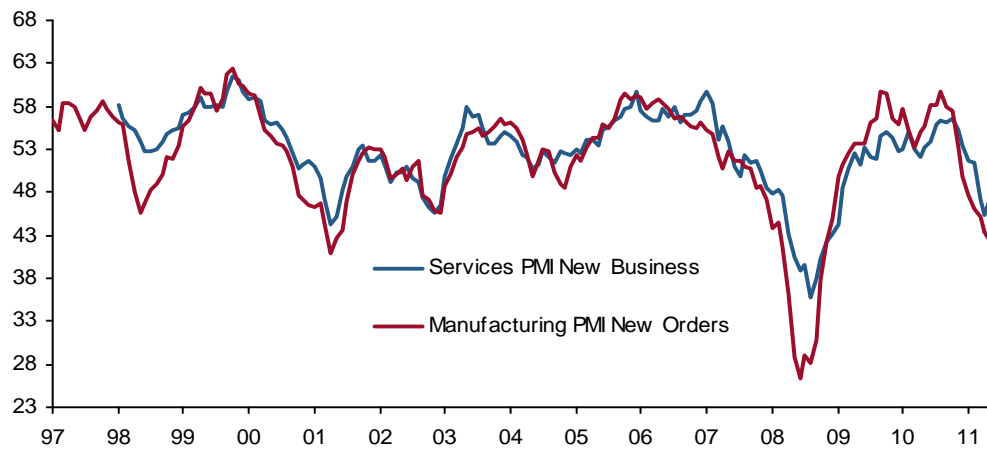


Exhibit 4: Euro Area Manufacturing and Services PMI



Source: Credit Suisse, Thomson Reuters DataStream

That this has, up till recently, been a slow motion process reflects the role of the ECB in funding the banks and accepting all sovereign bonds as collateral. And to its (limited) purchases under the SMP program.

But even that stabilizing function is no longer sufficient. Indeed, it has been the conscious choice of the ECB – and of the German government – to only partly stabilize the system in order to force through the radical political changes that would make the euro sustainable.

That real political movement is now starting to happen is welcome but should not lead to any complacency about the economic risks already unleashed.

In short, for reasons that stem largely from political failure and the flawed design of the original monetary union, the ECB is faced with the real prospect of depression and outright deflation across the euro zone. That the current German members of the ECB council do not see – or at least do not admit to this risk yet – is understandable but in the end does not change the situation that the governing council must deal with – by majority vote if necessary.

Since the Maastricht Treaty clearly states that the ECB's primary responsibility is to assure price stability we would strongly argue that it is NOT inconsistent with either its independence or its mandate for it to consider emergency measures to support growth and try to pre-empt deflation.

Indeed not to do so would in our opinion be a policy mistake to rival that of the Fed in the 1930s. And would in the end mean the end of independent central banking in the euro zone – and maybe elsewhere too – for a generation.

Judging only by its past responses to the most reliable leading indicators in the euro zone there is already a case for taking policy rates down to ½ or even a ¼%. See second chart on next page.

We think that is unlikely to happen at the 8 December meeting but a 50 basis point cut would be the minimum needed to signal its intentions to act decisively on growth and price stability.

Once it has done that – in effect exhausting the interest rate instrument – it will be better placed to consider what one might call conventional QE – expanding its balance sheet to purchase government bonds across the euro zone in proportion to the capital shares in the ECB itself.

That would neither be a dangerous jump to *de facto* fiscal union without adequate safeguards, nor a huge moral hazard issue, as committing to unlimited purchases of Italian bonds under the SMP program would be.

Nor would it be inconsistent with its primary mandate given the deflation risks now at work. But some members of the council should ideally start making this argument very soon, so as to prepare the way.

We note that our European economists have been – calmly, consistently and for several weeks – been making the argument that this form of QE is not illegal and likely to be needed in due course. See their note [here](#).

Obviously, this needs to be complemented by measures to help bank funding – with a 2, 3 or even longer LTRO (possibly with a variable interest rate to be re-set every 6 months) likely to be the main candidate. And it is the combination of these two measures that could have a galvanizing effect on confidence if it is not delayed too long.

Exhibit 5: Euro Area Final Demand with Recession Scenarios (logscale)

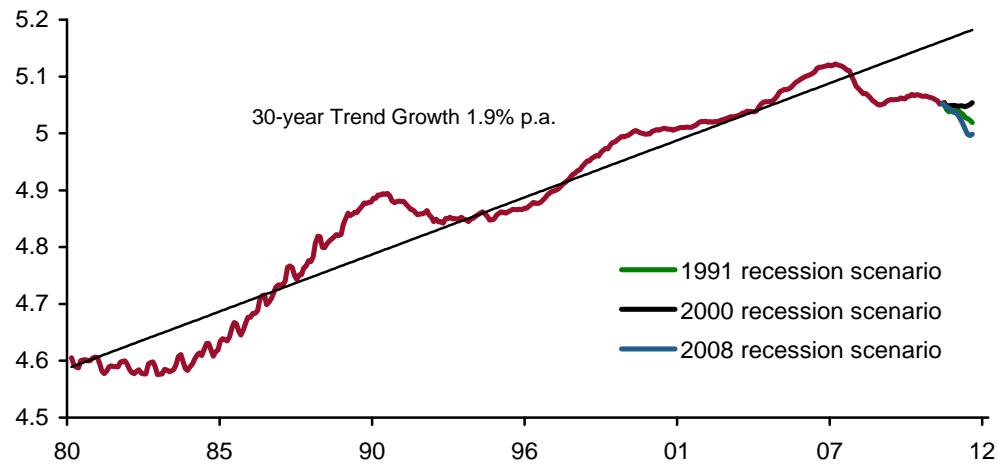


Exhibit 6: Euro Area Composite PMI and ECB Rate Changes

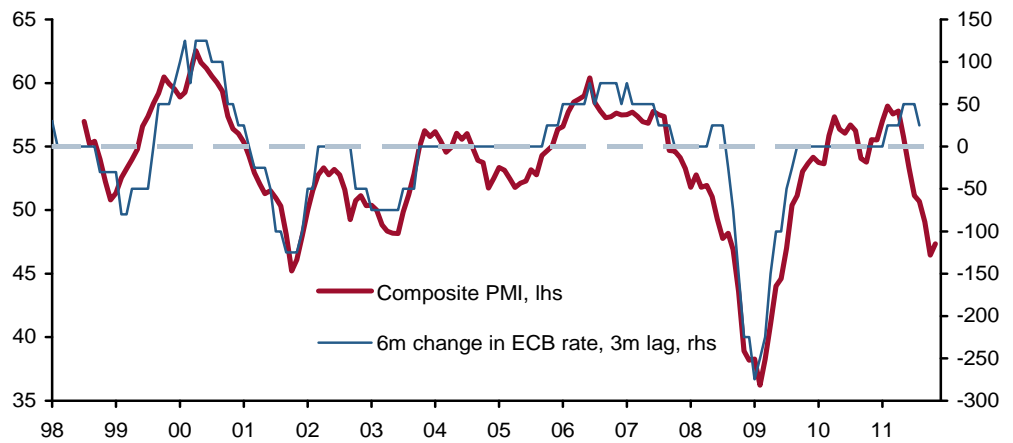
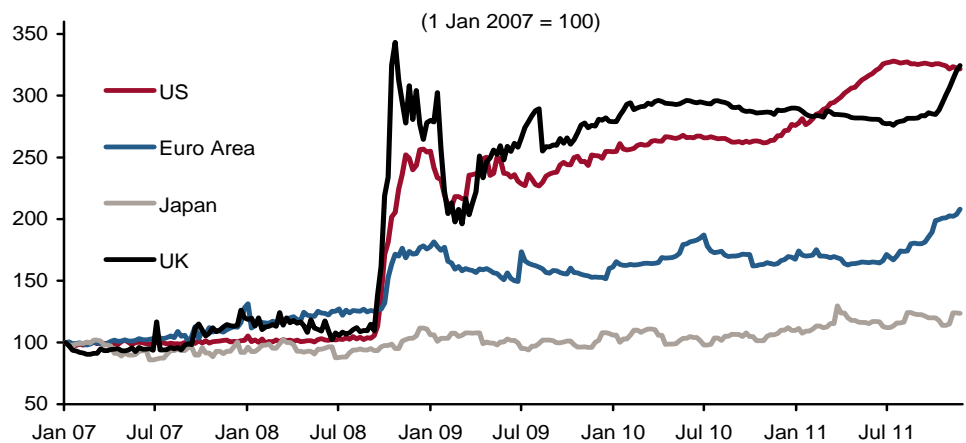


Exhibit 7: G3+ Central Bank Balance Sheets



Source: Credit Suisse, Thomson Reuters DataStream

Addressing The Systemic Flaw

European Monetary Union has been aptly described as a 1 ½ legged stool.

Quite apart from issues like factor mobility, trade patterns and wage and price flexibility the requirements for a stable monetary union are that it needs to be also some kind of fiscal and political union (the missing leg), and to have a transparent and credible lender of last resort (the half-leg). These two missing pieces are linked: it is doubtful whether you can have a fully transparent and credible lender of last resort without a viable fiscal union.

The ECB effectively knows that... and this point in itself creates a dangerous shadow of doubt about the ECB's capacity to support the banking system – especially in a break up scenario.

But since the economy falling into an even deeper slump would greatly increase the risk of break up – and banks not being able to fund in the private markets would force the economy into an even deeper slump – there seems to us little choice but to use all the ECB's current powers to address growth and financial stability in the manner suggested above.

But what the ECB probably won't and arguably should not do is to offer unlimited purchases of Spanish and Italian bonds under the SMP program. This is confusing, since it clearly has the mandate to act to ensure that the monetary transmission mechanism is working – including buying government bonds in the secondary market – and this is mistakenly thought to be the only form of (backdoor) QE the ECB can do.

But such measures are supposed to be limited and temporary and would run the risk of creating massive moral hazard and weakening the very basis for fiscal union before it has started.

So in this respect it is important to focus on the case for purely monetary QE and the need for any "pre-nuptial" agreement on fiscal union to be supplemented by credible and clear conditionality for any governments receiving help to fund current borrowing. Hence the IMF or EFSF channel needs to be used, and this is ultimately a fiscal not a monetary operation.

Still, it is the potential breakthroughs on political union that create the opening for the ECB to do "conventional" QE to counter deflation – rather than unlimited SMP purchases that could solve the bank stability and growth problem but only at the cost of undermining the creation of a "stability" union.

To make progress on the fiscal union probably needs agreement on something like the following set of measures:

- 1) All big countries pass a constitutional debt brake similar to Germany's.
- 2) A more credible (automatic) sanctions procedure for those countries who missed their fiscal targets.
- 3) An enhanced early warning system for pre-empting severe fiscal or trade imbalances building up within the system.
- 4) Some procedure for dealing with countries who persistently fail to meet their stability targets.
- 5) New institutions of common economic governance and democratic accountability .
- 6) In the longer-term, treaty changes to codify the above. Ideally treaty changes should be endorsed by all 27 members; agreement by euro zone members alone should be a last resort.
- 7) In the shorter-term, the strongest possible set of rules short of treaty change to ensure structural reforms and fiscal consolidation take place in weaker nations (such as the enhanced stability pact procedure now under discussion).

These are the issues that will dominate the European Council meeting on the 8th and 9th of December. Some form of in principle agreement on items 1 to 7 is the target but the most immediately market relevant issue is whether a breakthrough can be made on item 7.

Many of the thorny issues around that stability union remain unresolved and will not be solved within a few weeks. A rather good summary of them from a slightly different perspective is given in the article by Professor Charles Goodhart cited in the appendix.

These are issues for another day, but help to underline that the real drama of fiscal union has a long way to run, that will have no chance of getting to its destination without urgent steps to support growth and pre-empt deflation.

The thing that matters most in the short run is the quality and speed of any deal before year-end to put in place what we call the pre-nuptial agreement on fiscal union.

Despite the enormous pressure and urgency that has suddenly been injected into the political process in recent days, past experience suggests that yet another bout of market pressure may be needed to seal a credible deal. But if and when we do get there, the stage may be set for the ECB to become a serious deflation fighter. Most likely in January, in which case we are likely to enter a period of global reflation with G20 central banks, including China, easing monetary policy in various degrees and in various ways.

Appendix

The following short articles are all highly relevant to the European debate. None are very long. It's best to read the whole thing, but here are some teaser extracts for your convenience.

The euro: love it or leave it

Barry Eichengreen © voxEU.org

<http://voxeu.org/index.php?q=node/729>

The insurmountable obstacle to exit is neither economic nor political, then, but procedural. Reintroducing the national currency would require essentially all contracts – including those governing wages, bank deposits, bonds, mortgages, taxes, and most everything else – to be redenominated in the domestic currency. The legislature could pass a law requiring banks, firms, households and governments to redenominate their contracts in this manner. But in a democracy this decision would have to be preceded by very extensive discussion.

And for it to be executed smoothly, it would have to be accompanied by detailed planning. Computers will have to be reprogrammed. Vending machines will have to be modified. Payment machines will have to be serviced to prevent motorists from being trapped in subterranean parking garages. Notes and coins will have to be positioned around the country. One need only recall the extensive planning that preceded the introduction of the physical euro.

Back then, however, there was little reason to expect changes in exchange rates during the run-up and hence little incentive for currency speculation. In 1998, the founding members of the euro-area agreed to lock their exchange rates at the then-prevailing levels. This effectively ruled out depressing national currencies in order to steal a competitive advantage in the interval prior to the move to full monetary union in 1999. In contrast, if a participating member state now decided to leave the euro area, no such precommitment would be possible. The very motivation for leaving would be to change the parity. And pressure from other member states would be ineffective by definition.

Market participants would be aware of this fact. Households and firms anticipating that domestic deposits would be redenominated into the lira, which would then lose value against the euro, would shift their deposits to other euro-area banks. A system-wide bank run would follow. Investors anticipating that their claims on the Italian government would be redenominated into lira would shift into claims on other euro-area governments, leading to a bond-market crisis. If the precipitating factor was parliamentary debate over abandoning the lira, it would be unlikely that the ECB would provide extensive lender-of-last-resort support. And if the government was already in a weak fiscal position, it would not be able to borrow to bail out the banks and buy back its debt. This would be the mother of all financial crises.

What government invested in its own survival would contemplate this option? The implication is that as soon as discussions of leaving the euro area become serious, it is those discussions, and not the area itself, that will end.

Europe: After the crisis

Charles Goodhart © voxEU.org

<http://voxeu.org/index.php?q=node/7334>

Conclusions

Four points follow from the analysis:

- There is a need to revisit the political and economic underpinning of the Eurozone.

A monetary union does need some minimal centralisation of powers to work. We need to review what such minima may be. A look back at the exercise the Commission published in the early 1990s, "Stable Money – Sound Finances", would be a good starting point.

- The new Excessive Imbalances Procedure correctly shifts the focus from public-sector deficits/debts towards external deficits/debts; but the enforcement/sanctions component is misguided.

- The problem with the ratings agencies has been that they have downgraded sovereign ratings far too late, not too early.

A mechanism is needed to rectify this, and the Excessive Imbalances Procedure could be the right vehicle.

- The most severe Eurozone problems have arisen from the interaction between bank and public-sector debt.

There is no really good way to resolve this. Enthusiasm for bail-ins of bond holders is overdone. Bank taxes have numerous disadvantages. There is a case for building up a sizeable Eurozone sovereign wealth fund for use in emergencies.

Germany and the Eurozone: Clutching disaster from the jaws of victory

John Muellbauer © voxEU.org

<http://voxeu.org/index.php?q=node/7332>

Aided by market panic and confusion, it could be said that German toughness has transformed the reform prospects for Europe. Italy, Spain, and Greece now have credible, reform-committed governments. Ireland, bailed out under tough conditions, has cut its unit labour cost by 17% over 2 years and is showing growth. Portugal is strenuously reforming its public sector and labour markets. However, market panic has been costly for the European banking system and for short-run economic prospects.

All this would be a price worth paying, however, if Angela Merkel now completes the final stage of what would be seen as a remarkable moral, political, and economic triumph. A few years ago, a sleazy and ineffective Italian government could borrow on the markets at a cost scarcely higher than that of Germany. Last week, it cost the new Italian government over 6 percentage points more to borrow for two years than it cost the Germans. (see for example Manasse and Trigilia 2011). There is a way to put an instant stop to this absurdity without the European Central Bank and the European Stability Fund.

The German Ministry of Finance could offer a two-year loan to the Italian government at 3% above what it pays, and promise that next year, if the Italian reform programme is showing visible signs of success, the spread could fall to 2.5% and then to 2% if progress continues. With backsliding, the cost would rise. This solidarity gesture would be highly profitable for the German taxpayer. The conditionality of the offer would keep the new Italian government committed to reform, aiding Italy's credibility as a Eurozone member. Conventional Eurobonds, meanwhile, with the same funding costs for every country but with risk collectively underwritten, would likely be a recipe for disaster. They would encourage lax fiscal policy, backsliding on reform, and moral hazard. But conditional lending as illustrated above could be institutionalised in conditional Eurobonds as explained in my CEPR Policy Insight 59 (Muellbauer 2011)

Feedback on my own proposal has suggested possibly severe political obstacles to obtaining multilateral agreement on the spread-setting and distribution formulae needed to define conditional Eurobonds. These worries are exaggerated. Participation could be voluntary. As Boonstra (2011) points out, the AAA-rated countries could get together, agree the formulae, and issue Eurobonds. The other countries can then decide whether to accept the rules and be insured or try to borrow on their own.

Europe at a crossroads

Europe's economic outlook could be rapidly transformed. A German bilateral loan offer to Italy, followed by the announcement that conditional Euro-treasury bills would follow shortly, and that consultations were beginning on conditional Eurobonds, could be made within days. The yields on Italian government bonds would drop, followed by those of Portugal and Spain. Share prices of European banks holding Italian bonds would rise, restoring their ability to lend. The ECB's recent interventions in the Italian and Spanish bond markets would make a large profit. Speculators who have shorted sovereign debts of Italy and others could find themselves skating on thin ice.

There is, however, an alternative. Germany could prove itself not to be a good European and instead clutch disaster from the jaws of victory over fiscal irresponsibility, unreformed labour markets, and corruption in the southern fringe of Europe. German inaction could trigger the most severe crisis since the collapse of Lehman Brothers.

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