FINANCIAL TIMES

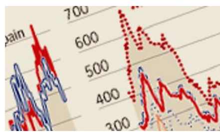
September 11, 2012 7:51 pm

Draghi alone cannot save the euro

By Martin Wolf

Last week's decision by the European Central Bank to make unlimited purchases of government bonds in secondary markets was both necessary and bold. Mario Draghi, the ECB's president, deserves credit for having obtained agreement for this controversial step, against the sole, albeit significant, opposition of Jens Weidmann, president of Germany's redoubtable Bundesbank. It is a pity that the ECB did not do this before the crisis in sovereign debt reached Spain and Italy. Yet this delay is not surprising: eurozone policy makers have, perhaps inevitably, done too little, too late.

It is not the ECB's fault that this action is too little. Its aim is to eliminate the risk of a eurozone breakup forced by the markets. But it cannot achieve this on its own. Ensuring the survival of the eurozone is a political decision. The ECB can only influence, not determine, the outcome.



Click to enlarge

The rationale offered for the programme of "Outright Monetary Transactions" is ingenious. The ECB insists that it does not aim to finance governments in difficulty. That, it insists, is a mere byproduct. At last week's press conference, Mr Draghi stated that: "We aim to preserve the singleness of our monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area. OMTs will enable us to address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro." In making this case, Mr Draghi argued that "you have large parts of the euro area in what we call a 'bad equilibrium' ... So, there is a case for intervening ... to "break" these expectations, which ... do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank". This then marks belated acceptance of strong arguments made by the Belgian economist, Paul de Grauwe, at the London School of Economics.

In its "Article IV" consultation with the eurozone, published in July, the staff of the International Monetary Fund argues that despite the low policy rates, credit conditions are extremely tight in some member countries. This, it argues, is due to divergent perceptions of the interlinked sovereign and banking risks, as well as a shrinkage in cross-border lending, as efforts are made to increase capital and liquidity buffers at home and place overnight deposits at the ECB. Today, in consequence, "financing conditions are the least supportive in countries where the crisis is the most acute." This dire situation gives a strong rationale for the new policy. (See charts.)

Yet the ECB will not intervene unconditionally. It will, instead, intervene if and only if countries meet specific conditions. The precise conditions will not be set by the ECB. Mr Draghi said that it was up to the governments, the European Union, the European Commission and the IMF to decide on the precise nature of these conditions. But, once agreed, they would need to be respected. That is the ECB's demand.

Such conditionality is perfectly understandable. But it must militate against the goals of the new programme. The ECB is saying that it will seek to eliminate the threat of a break-up, except when this threat is most real, which is. of course, precisely when the country is failing to meet policy conditions. Investors know that electorates might choose a government that has no intention of sticking to agreed conditions. What happens then? The answer is: either the ECB stops buying, in which case the bond market implodes, or the ECB continues, in which case conditionality is jettisoned.

This latter possibility seems the more likely: it will be hard for the ECB to stop. But that, too, might have dire consequences. Spurred on by opposition to this scheme from the Bundesbank, postwar Germany's most respected institution, swathes of German opinion hate what is happening to their money, as my colleague, Wolfgang Munchau, explained a recent column. It is easy to imagine what would happen within Germany if an important member country started to backslide on agreed policy conditions, while the ECB went on buying its bonds. The swelling rage would hardly strengthen confidence in the irreversibility of the euro. Nobody could be sure how German politicians would choose to respond – or be allowed to respond. At present, the government is quite supportive of the ECB. But that would surely not endure under all circumstances.

In brief, a conditional programme of bond purchases, implemented against the opposition of the Bundesbank, just cannot make the eurozone credibly irreversible.

Is there any way the ECB on its own could make it more credible that the eurozone will last?

The answer is: yes and no.

Yes, if people believed membership of the eurozone were clearly in everyone's interests, its survival would become far more credible. For that to happen, deficit countries need growth and jobs. The ECB could contribute by stepping harder on the monetary accelerator. After all, short-term economic prospects are dismal: the ECB forecasts real economic growth in the eurozone at -0.6 to -0.2 per cent this year and -0.4 to 1.4 per cent in 2013. By the second quarter of 2012, the eurozone's nominal gross domestic product was a mere 3.4 per cent higher than in the first quarter of 2008.

Yet the answer is also, alas, "no", because a more aggressive monetary policy would confirm German fears that the ECB was becoming the Banca d'Italia. The difficulty for the ECB is that relevant and appropriate measures are viewed, in Germany, as a giant step on the dismal path to hyperinflationary ruin. So long as this is the case, the ECB cannot make the euro look irreversible. That fact will undermine markets. That would force the ECB to buy more, so making the policy still less credible.

The ECB has done what it can, given the politics. The decision of the German constitutional court and the result of the Dutch election may help. But the risks of a breakup cannot be eliminated. If these are to disappear, citizens of debtor countries must see a credible path to growth, while citizens of creditor countries must believe they are not throwing money down a bottomless pit. What the ECB has done is win some time. It has not won the game.

martin.wolf@ft.com

Printed from: ttp: ft com cm 0 e bb0 fb 1 11e1 7ae 001 feabdc0 tml

rint a ingle copy of t i article for per onal e Contact if yo i to print more to di trib te to ot er

© THE FINANCIAL TIMES LTD 2012 and inancial ime are trademark of e inancial ime td