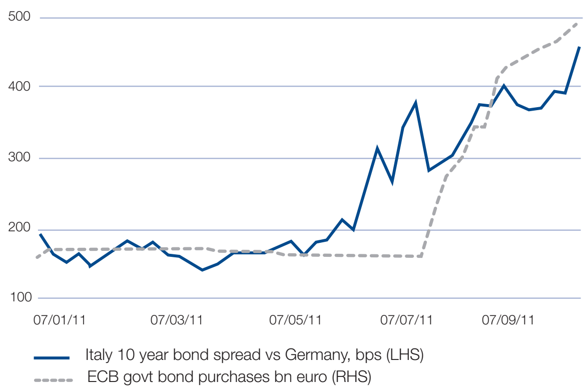
Will the ECB come to the eurozone's rescue?

Introduction

The recent G20 conference in Cannes was intended to build on the measures agreed at the Eurozone summit the previous week to help provide a sustainable solution to the debt crisis. In the event the conference was hijacked by the unexpected announcement from President Papandreou of Greece calling for a national referendum over the bailout package for his beleaguered country. This unhelpful development exposed the flaws of the Grand Plan agreed by the Eurozone politicians and raised the stakes not only for Greece itself but for the European Currency Union that is now being played out in the Italian bond market.

Subsequently, both the Greek and Italian Prime Ministers have fallen victims of the crisis and with Italian bond yields rising to over 7% it is becoming clear that something has to give. The prospect of a bailout for Italy is a scenario that the Eurozone could not allow to happen because the current rescue mechanisms do not have the resources to accommodate such a large economy. To prevent it happening and reverse the current contagion the only institution which can deliver a 'solution' is the ECB. The central bank has been actively buying Italian bonds in a vain effort to restore stability (see chart below) but with yields now at a level that effectively prohibits Italy from financing its debt, the ECB will have to make the decision as to whether it is prepared to be a lender of last resort. This means conducting unsterilized purchases of assets in the market without limit, otherwise known as quantitative easing (QE).

ECB government bond purchases



Source: Thomson Datastream

A breakup of the EMU: the taboo has been lifted

It is only two weeks since the Eurozone leaders agreed a three-pronged approach to solve its debt crisis but already it seems like ancient history as it has been overtaken by events that have rendered much of what was agreed either obsolete or ineffective. To recap, the package agreed to write-off Greek debt by 50% while at the same time enhancing the firepower of the European Financial Stability Fund to €1000bn and imposing a bank recapitalisation plan of €106bn. The three elements of the plan were supposed to be interdependent to prevent and hopefully reverse the contagion from Greece to other periphery countries and the banking sector.

The euphoria that greeted the Plan was quickly replaced by scepticism as it became clear that it would be a lot more difficult to raise the increased capital for both the banks and EFSF than originally envisaged. Part of the agenda at Cannes was to entice other countries and institutions to invest money in the EFSF that would give it credibility and help restore confidence to bond markets and the banking sector. Even before the G20 leaders met the response had been lukewarm and by the end of the conference the response was distinctly chilly. Chancellor Merkel of Germany was forced to admit that no external capital had been pledged to the bailout fund and without new money it will remain a paper tiger.

The turmoil in markets caused by the aborted Greek referendum produced a defining moment in this crisis from which there is no turning back. For Greece itself, President Papandreou's decision can be construed as positive as it forced the opposition to join a coalition government that is likely to produce a political consensus in support of the bailout package. However, it provoked an extreme reaction from Merkel and President Sarkozy of France who suggested that Greece would be voting on whether it would like to stay within the currency union or not ('the take or leave it' option). Notwithstanding the constitutional issues raised, this is the first time where membership of the Eurozone has been publicly questioned. It opens a Pandora's Box because it implies that membership is voluntary for which the corollary is that nations should not be liable for each other's debts. If Greece can leave the Eurozone then why can't Italy or other weaker nations?

The question of EMU membership introduces a currency risk to the Eurozone where before the risks had been centred on the government bond markets. If Greece was to withdraw and return to the drachma its former currency would suffer a significant devaluation against the euro raising the prospect of huge losses for liabilities denominated in euros. The same, mutatis mutandis, applies to any other country that leaves the union. Until last week the authorities had always insisted that a breakup of the Eurozone would not be countenanced and that any adjustment (such as the proposed 50% default of Greece as part of the Grand Plan) would take place within the Union in an orderly way.

A further unintended consequence has been to undermine the credibility of the new measures taken at the recent summit. The heightened uncertainty over Greece's status has led to bond yields rising to new highs and increasing the sovereign risk premium for the periphery countries. The Grand Plan was supposed to prevent the spread of contagion but with markets now fearful that a breakup of the EMU is possible, risk, as measured by the barometer of the bond markets, has increased. These developments made it much more difficult for the euro politicians to attract capital to the enhanced EFSF and, therefore, it has been left to the ECB once again to act as a fire fighter in trying to contain the crisis. In this respect the central bank has bought an estimated €75bn of Italian bonds, which has not prevented them rising to a new high of over 7% since the conclusion of the G20 conference. The best that can be said is that yields would have been even higher were it not for the intervention of the ECB.

The role of the ECB

Just a fortnight after the Grand Plan was announced it is obvious that it is not going to provide the long term and sustainable solution that the authorities hoped for. At the same time, the possibility of a disorderly default and exit from the Eurozone has been acknowledged by its leading politicians. This has led to increased contagion, especially with Italy, and threatens to undermine the rescue mechanisms upon which the salvation of the currency union depends.

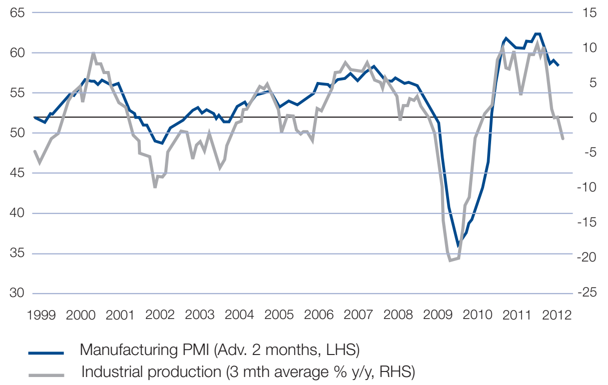
I continue to believe that the ultimate solution for the Eurozone is full fiscal as well as monetary union or a breakup. The prospects for a political and fiscal union still appear distant even though the various measures agreed in the last 19 months of the crisis represent some steps towards it. However, the likelihood of a breakup of the EMU, that would send shockwaves through the rest of Europe and beyond, have materially increased in the last two weeks. If the current constitutional framework cannot contain the crisis and the politicians lack the collective will to take the necessary decisions to provide a solution, the only other way a disorderly financial crisis can be prevented is for the ECB to increase its government bond purchases without liquidity absorbing measures (i.e. QE).

At present, the ECB is continuing to execute its Securities Market Programme (SMP) that it reopened in early August when contagion initially spread to Spain and Italy. Despite massive intervention it has failed to prevent peripheral government bond yields rising to new highs. This is partly because of the limited nature of the SMP but mainly because it is reactive to market movements. The new President of the ECB, Mario Draghi, was asked in his maiden press conference about the extent of the central bank's bond purchases and whether it would consider unsterilized purchases. Although he did not rule it out Draghi said the SMP as it currently stands is 'limited in amount', 'temporary' and to 'restore the functioning of monetary transmission channels'. Therefore, QE does not appear to be on the agenda for the time being although there is more the central bank can do before it presses the nuclear option.

What else can the ECB do before it resorts to QE?

The new President surprised markets last week by announcing a 25bps cut in interest rates at his inaugural meeting, partially reversing the two rises earlier in the year. This takes the rate down to 1.25% that is still relatively high compared to other developed market economies where the rate of growth and inflation are generally higher than the Eurozone. Draghi has quickly established himself as a pragmatist since he openly acknowledged the downside risks to economic growth in the Eurozone. The conundrum that he faced was that the sole mandate of the ECB is to keep the rate of inflation below or close to 2%. The most recent reading for inflation was 3% but Draghi justified the cut on the basis that the slower rate of growth would contribute to inflation undershooting its target in 2012. Recent data for the Eurozone has been terrible and the region may already be in recession, as Draghi conceded. Previously, the continued strength of the dominant German economy has offset the deterioration of the weaker periphery states but recent data also suggest that Germany is slowing down fast (see chart opposite).

German Industrial Production & Manufacturing PMI



Source: Thomson Datastream

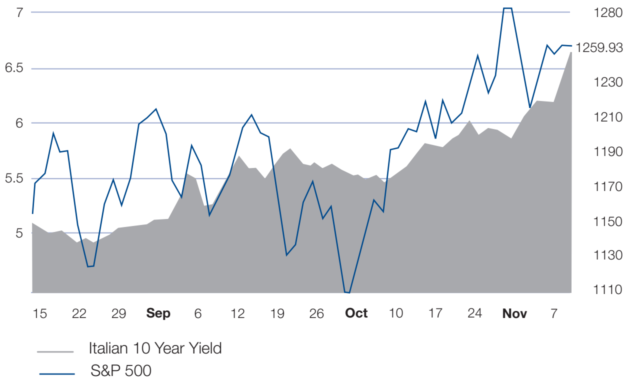
Given the weak growth environment the interest rate reduction by the ECB means that further cuts are probable (maybe as early as next month). In the crisis of 2008-09, the ECB never cut rates lower than 1% but with the current crisis centred on the Eurozone itself, a lower rate appears possible. While rate cuts will help the cost of borrowing for the banks and other debtors, much more will be required if the crisis enters a more acute phase. Already the ECB is extending the liquidity facilities to the banking sector that has become more reliant on the central bank for its day to day funding needs. Deposits from the commercial banks into the ECB have also soared due to risk aversion and requirements to improve capital strength. Such measures, however, are only palliative and will not provide a solution to the crisis. If the bond yields of Italy, in particular, and other periphery countries continue to climb to levels where they cannot finance themselves a different response is needed.

As a precursor to full QE, the ECB could help finance the EFSF itself by accepting the bailout fund as a bank and acting as counterparty for its open market operations. This could be done directly with the EFSF or indirectly via commercial banks which could conduct repo operations with the EFSF and use the collateral to get funding from the ECB. This form of leveraging up the EFSF was discussed as a possibility in the run up to the Grand Plan but rejected in favour of the monoline insurance scheme and Special Purpose Investment Vehicle. Although using the ECB in this way would be a much more effective way to leverage up the EFSF, it would face considerable political hurdles not least from Germany where it would require full Bundestag approval. (Previously it was vetoed by Germany so it would require a volte face from the Eurozone's largest member). However, at present it is clear that the EFSF is not going to attract sufficient capital to provide an effective firewall to prevent or reverse contagion spreading under the plans announced on 26 October. When the EFSF first launched bonds last year they attracted considerable investor demand from outside the Eurozone because they were seen as low risk backed by AAA credit rating. The first bond was priced at a spread of only 14bps over German bunds whereas the most recent spread is over 100bps. Last week the fund had to cancel an auction of only €3bn due to lack of investor demand and it is becoming clear that the EFSF is itself at risk of becoming shut out of capital markets.

Although the EFSF is impotent in its current form, I believe the ECB is unlikely to finance the EFSF through its repo operations as the legislative and political hurdles are too great. To implement such a scheme would meet with much resistance, especially from Germany, and if a response is needed time will be of the essence. At some point President Draghi and other members of the committee will have to decide whether the ECB is going to assume responsibility to save the euro by repudiating the central bank's monetarist principles and implementing unsterilized purchases of bonds. From within the ECB this prospect is more likely under the new President who has already proved to be more dovish than his reputation suggests by cutting interest rates at the first opportunity. Furthermore, the committee itself is now dominated by members from Southern Europe following the high profile resignation of two German committee members earlier in the year in protest at the increasing looseness of ECB monetary policy.

Despite the failure of the Grand Plan and G20 Summit to move towards a sustainable solution for the debt crisis, risk assets have been surprisingly resilient in the face of the constant negative newsflow emerging from the Eurozone (see graph).

The resilience of equities (S&P) to the rise in Italian bond yields



Source: Thomson Datastream

The strength of equity markets is partly due to prevailing pessimism in financial markets about the ability of the Eurozone authorities to take the necessary decisions to provide a sustainable solution to the crisis. In addition, although recent news has been predominantly negative it acted as a catalyst for changes that have been regarded as positive with the resignation of both the Greek and Italian Prime Ministers. However, the increasing prospect of QE by the ECB has also been important and added to the allure of equities against other asset classes.
Even though the implementation of QE would be an acknowledgement that the crisis has reached epic proportions, it represents a monetisation of the debt of the Eurozone countries. As we have seen in the UK and US the controversial policy of QE has added to liquidity that has acted as a boost to risk assets such as equities and commodities. Furthermore, the policy is potentially inflationary as it adds to the stock of money in the economy and even if inflation does not respond in the short term to the monetary stimulus, inflationary expectations will rise in Europe if QE were to be pursued. On a longer term basis the effect could be much higher inflation which is partly why it has met such resistance within the Eurozone, especially from Germany that still bears the scars of its hyperinflation between the two world wars.

What are the impediments confronting the ECB if it decides to go ahead with QE?

The ECB was established in the image of the Bundesbank, Germany's central bank (it was designed by former Bundesbank member Otmar Issing). As such, it has a sole mandate that is to maintain the rate of inflation at or below its target of 2%. The Bundesbank and later the ECB have both prided themselves on maintaining price stability within Europe in contrast to some other central banks that have pursued looser monetary policies following broader mandates which have contributed to higher and more volatile rates of inflation. The corollary of the Germanic monetary policy implemented by the ECB is that it has been consistently hawkish in its interest rate policy and would never consider something as liberal as QE.

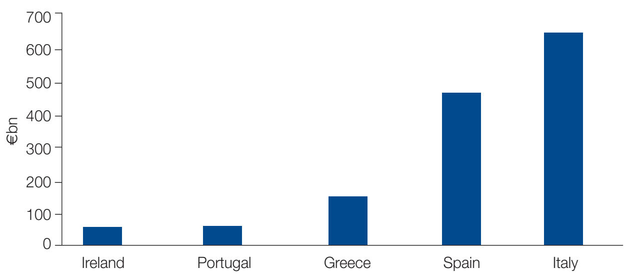
Thus, the main impediment for the ECB in conducting QE will be whether Germany will oppose it. In theory, the ECB could go ahead without Germany's blessing but from a practical point of view that is very unlikely given the history of monetary policy in the EU and the fact that Germany is the dominant member of the Eurozone. At present, there is little sign that Germany is moving to a more dovish stance on monetary policy as the resignations of Weber and Stark from the ECB committee have recently illustrated. However, if it came down to the choice between a breakup of the EMU and a debasement of the currency via QE, Germany may be forced to swallow its principles in order to preserve the Eurozone and its currency.

There is also the question as to whether QE would be legal. The ECB has often stated that it has no mandate to act as a lender of last resort to Eurozone members and it would be a breach of European law. Article 103 of the European Treaty states that the Eurozone should not become liable for the debts of member states and Article 101 prohibits the ECB from lending to governments. The original treaty also prevented bailouts which the policy makers managed to circumvent so it is conceivable that a flexible interpretation of the above Articles could allow QE to still take place. However, the existing legislation will act as a deterrent and even if supra national laws are by passed the German constitutional court would probably challenge the legality of such a move as a test of Germany's remaining membership within the Eurozone.

A further reason to doubt the implementation of QE is that it would encourage moral hazard. The reason that the Eurozone authorities have been so insistent that harsh austerity measures should be imposed on the countries seeking bailouts is to act as a deterrent for future profligacy in the country concerned and fellow member states. The same principle will apply to the concept of QE. If it were to go ahead it would be seen as a green light for countries to continue to act in a fiscally irresponsible way as they would be safe in the knowledge that the ECB would act as a guarantor of its debts. The ECB would effectively lose its independence, which is one of its central tenets, as it would have to bow to the demands of governments and bond markets.

The Securities Market Programme has led to an unplanned and unwelcome dilution in the quality of the ECB's balance sheet. The ECB has said that it was prepared to step in to provide short term stability to the Eurozone while the politicians built up the rescue mechanisms that were meant to relieve the ECB of its duty. If the central bank opted to implement QE it would damage its balance sheet even more, especially if Greece or other countries were forced to leave the EMU. QE purchases may be able to limit contagion in the secondary bond market but it could still be difficult for countries to raise money in the primary market; Italy has a significant funding hump during the rest of this year with almost €32bn of debt to roll over in November and €362bn in 2012. The chart below shows the financing needs of all the periphery countries until 2014 and highlights how severe the funding requirements for Italy have become.

Gross Government Financing Needs until December 2014 (€bn)



Source: Thomson Datastream

All these considerations will have to be weighed up by the ECB committee if it was to take the momentous decision to implement QE. Given its past pronouncements and the still considerable German influence on Eurozone monetary policy I believe that a further deterioration in the crisis will have to take place before it occurs. However, events are moving so fast that the day of reckoning could be soon.

Conclusion

The failure of the Grand Plan and the G20 conference at Cannes to provide a solution to the Eurozone debt crisis has raised the stakes for the ECB. It is clear the EFSF has not and will not have the necessary firepower to stabilise bond markets and provide a firewall to prevent contagion spreading. The only institution within the Eurozone that can do this is the ECB but it will have to change its currently policy of intervention through its Securities Market Programme (SMP) to one of unsterilized asset purchases through QE. This is anathema to the philosophy of the ECB, which has always been steeped in the tradition of German monetary policy. Although that influence is fading with new members on the ECB committee and an incoming Italian President, it would still be very difficult to implement QE without Germany's blessing.

Yesterday Italian bond yields have shot through the important threshold of 7% and with the crisis engulfing the Eurozone's 3rd largest economy it can no longer sustain borrowing costs at such elevated levels. A bailout is not possible within the current framework of the Eurozone as Italy's debt is almost three times the combined debt of Greece, Ireland and Portugal. If the authorities do not want to risk a breakup of the EMU the ECB will have to step in soon.

Ted Scott November 2011

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