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Austerity alone can’t save the euro

By Wolfgang Münchau

On Friday, Mario Draghi said “no”. The president of the European Central Bank declared that the eurozone crisis was a crisis in need of a political solution and the ECB would not bail out anybody. To underline the message, the ECB’s governing council had earlier in the day put up a ceiling of €20bn on its weekly bond purchases.

The consequence of these statements and decisions is that the eurozone crisis could well get worse in the short term. There is no political solution in sight. Angela Merkel, the German chancellor, rejects a eurozone bond. The European financial stability facility is too small to handle countries the size of Italy or Spain, let alone both. Even a fully operational, leveraged EFSF would not be in a position to give a “whatever it takes” bond purchasing guarantee.

The consensus view in Brussels and Berlin is that the crisis can be solved by technocratic governments imposing structural reform and austerity. That proposition is, in my view, insane. In any case, it will be tested shortly. Mario Monti, Italy’s new prime minister, is about to introduce a programme of reform and austerity. I wish him luck, but I doubt the bond markets will change their view on the sustainability of Italy’s debt in the absence of outside intervention. We have gone way beyond the point at which this crisis is solvable by standard instruments of economic policy. The survival of the euro will now depend on whether Ms Merkel or Mr Draghi, or both, will blink.

This may yet happen, but not right away. The ECB is facing more formidable legal constraints than those who call for an intervention acknowledge. The bank is technically allowed to engage in secondary bond market purchases, but not with the aim of helping governments incur deficits or roll over debt. Article 123 of the Treaty for the Functioning of the European Union says the ECB shall give no overdrafts to governments. Clearly, the euro was sold on the grounds that the ECB would never do what it is being asked to now. Such a law is testimony to a lack of realism, especially given what we know about the history of financial crises. But trying to solve a crisis by getting round a law, even a bad law, is not sustainable either. For that reason, I agree that it is probably not a good idea for the ECB to issue unlimited and unconditional blanket guarantees, or give unlimited finance to the European rescue fund.

But there is one thing it could do, even under the present law. The ECB could launch a very large programme of quantitative easing. It could undertake secondary market purchases with the aim of bringing down long-term interest rates to a desired level, as its short-term policy rates are zero bound. That would clearly constitute a monetary policy operation.

The case to do so is overwhelming. The eurozone has already entered a recession, driven by three factors, each serious on its own and lethal in combination: a slowdown of the global economy; pro-cyclical fiscal austerity programmes; and a much larger than expected deleveraging of the financial sector. If present policy prevailed, the eurozone would be in danger of falling into a depression.

A quantitative easing programme would address the recession and the market funding crisis at the same time. The ECB could plausibly impose a cap on long-term market rates of, say, 4 per cent, and buy long-term debt securities.

The ECB will probably not take such a decision right away. Mr Draghi has only just arrived in Frankfurt, and is unlikely to push for a policy for which his governing council would have to overrule the two German representatives. The composition of the ECB board will change in 2012, which might offer a window of opportunity for a policy shift.

But this also means that the crisis will remain unresolved for some time. In present market conditions, a leveraged EFSF is unrealistic. So how long can this policy vacuum be sustained? So far, the speed of the crisis has exceeded the speed of the political response. The next political turning point will come at the European Council meeting in December, which will need to decide something more substantial than previous summits.

If that does not happen, we will be getting closer to the point where member states – confronted with an unsustainable funding position – could rationally conclude that the political and financial costs of staying in the eurozone may well exceed the costs of an exit. This is not a proposition anybody would want to test. Once the eurozone goes down that road, it will not come out of this crisis in one piece.

The moment will arrive, probably sooner rather than later, when Mr Draghi and Ms Merkel will have to blink simultaneously. The odds of that happening are neither low nor high. They are indeterminate. It is the worst kind of uncertainty imaginable.

munchau@eurointelligence.com