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ECONOMIC TALKING POINTS

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September 6, 2012

A Fed Up Mario Draghi Is Ready To Have The ECB Take The Lead

After three years that saw the Eurozone lurch from one financial crisis after another, ECB president Mario Draghi and most of the 23 voting members of its governing council have chosen to double down, both monetarily and politically.

Despite persistent opposition from the Bundesbank to any strategy that would allow the ECB to aid troubled European countries by buying more government debt, that is precisely what Mario Draghi is now prepared to do --- and on a scale never seen before. (Hey, the Bundesbank for all its bluster still has only one vote in 26 when it comes to monetary policy.) The ECB's goal is to create enough demand for those securities to keep their yields from rising to crippling levels.

The precise modalities on how and when these transactions will occur have yet to be ironed out. Nevertheless, some aspects of the plan appear more crystallized.

(1) The ECB is willing to step into the secondary market to buy unlimited amounts of short-dated government bonds to bring yields down to manageable levels.

(2) The ECB is prepared to purchase the debt only of countries that have formally asked for a bailout from the European Financial Stability Facility (EFSF). As of now, neither Spain nor Italy has sought a bailout, while Greece, Ireland, Portugal, and Cyprus have.

(3) To prevent the new bond purchases from swelling Europe's money supply, the ECB will sterilize their transactions by mopping up funds elsewhere in the debt market.

(4) The ECB will not have seniority on the bonds it buys, which means it will not seek better treatment than other creditors.

(5) While the ECB is willing to bring interest rates down on certain government debt, it will not divulge what those yield targets will be.

(6) Any country that reneges on its promised reforms as a condition for getting aid from Europe's rescue fund can no longer count on the ECB to buy their government debt.

What may be Draghi's rationale for stepping up the ECB's role?

First, the festering financial crisis has now deepened the recession in Europe and further endangered the stability of its banking system. Not only is the EZ economy shutting down, according to recent indicators, it is also undermining economic activity in Germany. Today, the ECB projected a more serious economic downturn for the region, with business activity shrinking by 0.4% this year, not the 0.1% it had forecast last June.

Second, since 2010, the EZ committed more than 380 billion euros in loan pledges to troubled countries, yet that still failed to keep the bond yields from rising among the ailing countries, and it certainly has not slowed their economic decline.

Third, there was wide spread belief among investors that Greece will exit the Eurozone this year or next --- which would set the stage for the entire single currency system to eventually collapse. Draghi's latest bond-buying plan was to meant to send an unambiguous message to investors that the Eurozone is here to stay, with the euro irreversible, and that ECB is prepared to use all its resources to hammer those points to any and all skeptics.

Fourth, Draghi and others within the ECB realized that in the final analysis, Germany has no choice but to agree with the ECB's bond-buying program. Germany has benefited greatly by the euro. It is inherently cheaper than the Deutsche Mark would have been and this has allowed Germany to prosper through greater exports and rising employment. Simply put, the euro has been the golden goose for Germany. If Greece, Spain, Portugal exited the EZ, the single currency system would consist only of financially healthier economies. Investors would then bid up the price of the euro to levels that would likely slash export growth.

Fifth, Germany's Angela Merkel has become more conciliatory lately after realizing that austerity alone did not work. To her, the ultimate question is what will cost Germany less? Should it allow Greece to default and exit the euro, with the possibility of investors betting other nations will follow and thus hollow out the EZ? Or should Germany work to keep Greece in the EZ, allow more time for reforms to be carried out, and permit Europe's rescue fund and the ECB to facilitate the recovery process? Merkel realized the latter was the better choice, not just for Germany but for her legacy as well. The last thing Merkel would want is for history to reflect that she was the powerful German leader that oversaw the first big reversal in Europe's 60-yr integration process.

Bottom line:

Draghi appears intent to push back at the Bundesbank opposition and allow the ECB to provide all the liquidity necessary to finally turn Europe's fortunes around. It's a big step forward to address the debt crisis, but many questions still remain. The German Supreme Court will rule next week (September 13) if the European Stability Mechanism and Fiscal Pact violate German law. A ruling that it does may throw a wrench in the chain. We also have to see if Spain and/or Italy formally seek financial aid from the rescue fund so the ECB can act on their behalf. Finally, and most importantly, we need to see if private investors have grown more confident that the euro is indeed here to stay and whether they believe Europe's recovery process is now underway. Our view is that the latest announcement by the ECB will prove effective and thus we have raised our forecast for growth in the Eurozone to 1.5% in 2013, from 0.9%.

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