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GLOBAL MACRO

After a Summer Break,

The Carrot and the Stick

After several weeks of major uncertainty, investors hailed the ECB's promises of late July, and the month of August provided a welcome lull. The two key questions are how long it will be before they start demanding follow-through on those promises, and just what the much-awaited measures will entail. By requiring Spain and Italy to request assistance from the EFSF rescue facility before agreeing to purchases of their government debt, the European leaders will only drive the EU even further into the morass it has been mired in for more than two years. And a growing number of countries in the region will inevitably get dragged down in the process. Unfortunately, those leaders show little inclination to do otherwise.

"The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Mario Draghi, London, July 26, 2012

Although many feared the worst, the summer turned out to be fairly uneventful. The Greek elections on June 17th didn't push the country out of the Eurozone; the French-German relationship didn't break up; neither Spain nor Italy crossed the critical thresholds that would have sent them into deep freeze. In fact, the spread of the sovereign debt crisis to these two major economies in Southern Europe has had its upside as well. Upward pressure on Italian and Spanish yields has taken some of the heat off of Greece, giving the new Samaras government the breathing spell it needed to try to work out a viable strategy for keeping the country in the Eurozone. Greece has emerged with improved governance, and last week the discussion process with its European partners resumed in an infinitely more serene atmosphere than in the spring. In addition, awareness of the huge risks to the euro area of any further deterioration in Spain and Italy has forced Europe's leaders to clarify their thinking in a hurry. The result became apparent at the Global Investment Conference on July 26th when ECB President Mario Draghi boldly stated: "[Within our mandate,] the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Promptly rebounding from the big scare they experienced in early summer, the markets hailed this temporary showing of determination. Visibly undaunted by recent dire statistics that validate forecasts of a Eurozone recession, the Euro Stoxx 50 has gained 12 percent in the past month, the Italian and Spanish stock markets show an increase of over 20 percent, and the euro, after sliding below the $1.21 mark on July 24th, closed last Friday at better than $1.25. No doubt about it: Mr. Draghi can feel very good about how effectively he communicated.

What Happens Now?

While investors have momentarily been reassured by Mr. Draghi's promises, you can safely bet that they will soon be demanding follow-through on those promises, which boils down to purchases, in one way or another, of Spanish and Italian government bonds in amounts large enough to drive down borrowing costs significantly for both countries. With GDP shrinking and national debt exceeding 70 percent, in the case of Spain, and 120 percent, in the case of Italy, **mounting borrowing costs have become a limitless source of tension that no short-term austerity program has the slightest chance of alleviating. If anything, austerity will make things worse.** Investors are clearly aware of this, as attested by the upward pressure on bond yields that followed the announcement in mid-July of the Rajoy government's new package of drastic spending cuts. Given that the Spanish economy was already on its knees, it didn't take long for what was initially lauded as a step toward sound fiscal management to be re-interpreted as an additional contributor to slump conditions, and therefore as a further cause of higher borrowing costs for the Spanish government.

Putting an end to this spiral is a crucial prerequisite to mitigating the sovereign debt crisis. This will require substantially lower lending rates and above all extending the deficit reduction timetable for Eurozone countries. But while good intentions have been expressed, there is not much else in evidence. Not only has the ECB refrained from indicating the size or time frame of its planned bond-buying program; it has also remained studiously vague about the conditionality that will apply. The European leaders are demanding that troubled countries officially request assistance from the European Financial Stability Facility (EFSF), which means signing up for further structural adjustments—the current EU term for "austerity program." In doing so, they will only drive the EU even further into the morass it has been mired in for more than two years. And a growing number of countries in the region will inevitably get dragged down in the process. Unfortunately, that may just well be the outcome that Europe's leaders would currently prefer.

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