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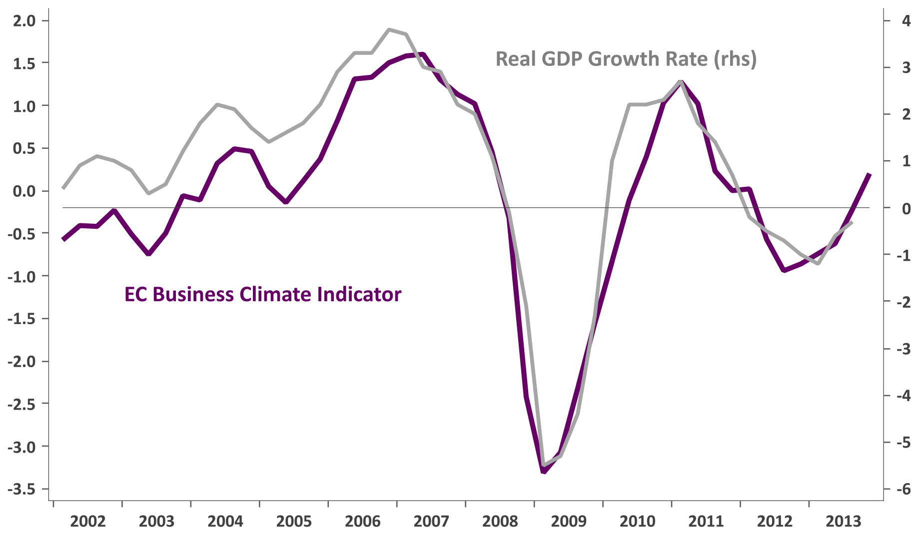
GLOBAL MACRO

Let's Not Kid Ourselves, Mr. Draghi

The euro area is unquestionably doing better. In fact, it's now the world region with some of the most upbeat indicators, from business climate survey results to industrial production and the outlook for exports. **So the first quarter will see growth across the currency bloc—far from dazzling, no doubt, but still well above prior expectations. But let's not kid ourselves: eurozone countries are going to be in trouble unless they get additional monetary policy support.**

Business Climate and GDP Growth in the EMU



Sources: RichesFlores Research, Macrobond

For starters, the degree of visibility we currently have on the economy has basically left us flying blind—meaning there are no guarantees that the improvement under way will continue beyond the first few months of the year. We doubt it will. Why? Because the necessary global growth drivers are sorely lacking.

- The latest indicators show that the American economy is by no means out of the woods. And even if it manages to avoid going into reverse, as long as deleveraging requires a shrinking current account deficit, the U.S. can't provide the rest of the world with the kind of stimulus it once did.

- Meanwhile, emerging economies are in the midst of a deep crisis, largely due to a sharp slowdown in their export markets over the past two years—the Chinese market in particular. Moreover, China ships 35 percent of its own exports to developing countries, so the economic tsunami that has hit them is bound to wash up onto Chinese shores—and subsequently onto European shores as well. When it does, the primary victims will be Germany's export firms, since they are heavily dependent on those markets.

All this makes it hard to believe that the respite the eurozone economy is now enjoying will turn into a lasting upswing.

Furthermore, a few months of recovery are not enough to nip deflation in the bud—a lesson the Japanese have learned over and over in the past fifteen years. The E.M.U. has 19 million job-seekers and falling real estate prices. Lending to the private sector is stuck in contraction mode. Excluding Germany, the currency bloc's GDP has shrunk by 5 percent in the last five years (20 percent in Greece, 10 percent in Italy, and 8 percent in Spain and Portugal). Wages have risen on average by less than 1 percent a year. The euro is high relative to other currencies. In short: all the forces required for deflation to gain traction are already at work.

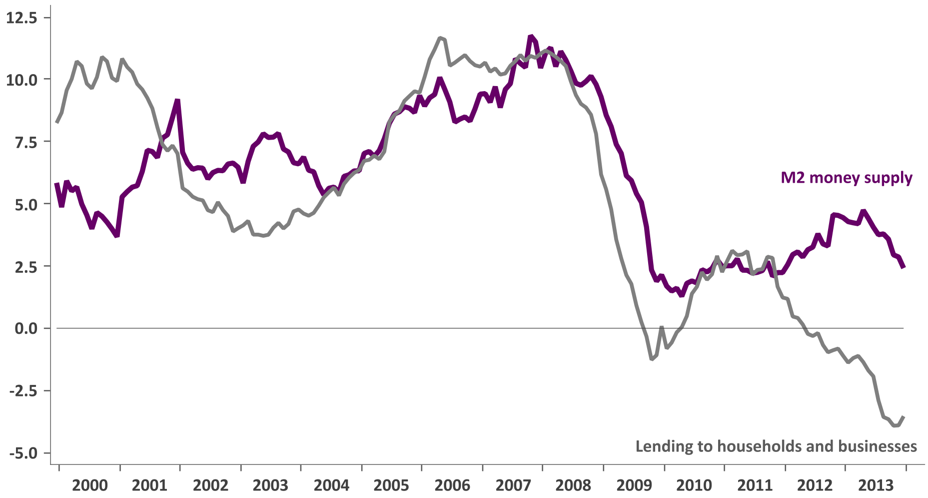
Real GDP, Q1 2008=100

Sources: RichesFlores Research, Macrobond

Postponing decisive action to counter those forces would clearly be a big mistake. So what can and should be done?

- **An end to the ECB's sterilization policy**—which prevents the central bank from purchasing government bonds and thereby adding liquidity to the economy—is the very least we can ask for. The first weapon in a central bank's anti-deflation arsenal should be expanding the money supply. By itself, however, such a move by the ECB will inevitably fall short of the mark—and may even have next to no impact in today's economic conditions.

Annual Growth in the Money Supply and Lending to the Private Sector in the Euro Area (%)



Sources: RichesFlores Research, Macrobond

- **Cutting the ECB's main refinancing rate from 0.25 percent to 0.1 percent** is a further option. But can we reasonably expect this to be anything more than a flash in the pan—or to have any real effect on the economy?

Today's challenges clearly call for responses of an entirely different order—responses that will almost certainly require going beyond the ECB's mandate. Even in the best-case scenario, this will take time. And with the deflationary symptoms spreading fast, time is precisely what we don't have.

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