SPECIAL FX

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Stark Revelations

Comments by European Central Bank board member Juergen Stark may be more important than the market initially understood. He indicated that the sovereign bonds that the ECB purchases will be held until maturity. This is significant in terms of debt restructuring. Many observers have seen the dramatic decline in the risk premium that Club Med and especially Greece pays over Germany as well as the decline in credit default swap prices, and have argued that the EU/ECB/IMF plan reduces the risk of a debt restructuring. We do not think it is that clear.

Officials have indicated that the amount of sovereign bonds that the ECB purchases will not be made publicly available. This is part of the "force multiplying strategy" that allows it to preserve strategic ambiguity so that market forces will not have a fixed target to shoot at. It is possible that a careful examination of the central bank's balance sheet will reveal important details, unless this is removed from public access too.

Some economists used to discuss central bank intervention in the foreign exchange market as "stabilizing speculation." It may be helpful to think about ECB bond purchases in a similar context. The ECB's purchases of Greek bonds shifts the ownership from weak hands, primarily European banks whose investors are impatient and demand quarterly performance, to the stronger and more patient hands of the ECB. One form of debt restructuring could be lengthening maturities. It would likely be easier for the ECB to agree to lengthening maturities of Greek bonds than their current holders. The combination of ECB purchases and commitment to hold until maturity would seem to be consistent with a smoother restructuring exercise at some point in the future.

Integrationists vs. Hard Money

The decision by the ECB to buy sovereign bonds in the secondary market appears to have come over the objections of Bundesbank President Axel Weber. Some observers and journalists draw the conclusion that Weber's objections damaged his campaign to be the next ECB President when Trichet's term expires next year. Yet this may be too simplistic of a linear projection of current trends.

There seems to be a clear split in European policy-makers. Arguably, the crisis did not create the divide, but brought the historic fissure into stark relief. The first camp sees an opportunity, or perhaps the necessity, of greater integration. Illustrative of the Integrationists is European Commission President Jose Barroso, who said that monetary union is not possible without economic union. Some in this camp are pushing for the development of a single European bond market. The latest policy response form the EU/ECB/IMF appears to be a victory for the Integrationists.

Ironically, it seems that the ECB's decision on May 6th to say nothing and do less in the face of the growing disruption in the global markets helped intensify the crisis and ultimately was the cathartic event that provided the catalyst to overcome the resistance of those that opposed the Integrationist strategy. While some of the opposition are simply euro skeptics, there are others that are concerned that monetary union will become a transfer union, where the richer and more competitive countries subsidize the poorer and less competitive countries. This side may be thought of as the Hard Money camp. The Hard Money camp is not necessarily anti-integrationist. They are likely supportive of stronger enforcement of fiscal commitments and better coordinated fiscal policy. However, they are concerned about the moral hazards, and the inflationary and competitive risks posed by the Integrationist strategy.

Hard Money to Secure ECB

ECB President Trichet has suggested that a European bond market has not even been envisaged and would, in any event, represent a significant obstacle to evaluate fiscal policies on a country basis. Surely, Trichet cannot be considered a euro skeptic. Indeed, this Hard Money camp may be sympathetic to some types of integration, such as new agreements on enforcing the fiscal discipline rules and some greater fiscal oversight. While the Hard Money camp has been bowed by the recent decision, they have not been defeated. There will be a backlash as surely as day follows night.

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There is a sustained adversarial conflict between the Integrationists and Hard Money camp. Battles are won and lost, while new issues emerge to be contested. As we have noted, the Integrationists see the benefits of a European bond market (in additional to national bond markets). The ECB, or at least Trichet, does not. The ECB wants to sterilize the bond purchases so as not to impact money supply, which incidentally is contracting on a year-over-year basis. Some EC members suggest this is still to be worked out.

It is in no one's interest to have a weak ECB. Given the victories of the Integrationists, it makes Weber an even stronger candidate to succeed Trichet.   After being over-ruled several times in recent months, or seeming to reverse initial stances, bureaucratic politics dictate that the ECB have strong leader who will jealously protect the central bank's independence. Given the clear inflationary risks inherent in the latest policy response, a candidate with strong anti-inflation credentials may also be perceived as needed even more now. Who better than a Bundesbank President? Moreover, given the clear and understandable reluctance on the part of Germany to be continuously opening up its purse, the stars appear aligned for a German to finally head up the ECB for the first time.

Judging the Great Experiment

It has been said that when asked about the consequences of the French Revolution, the first premier of the People's Republic of China quipped in the early 1960s that it was too early to tell. Yet after a less than a 12 year period, many observers are claming the great European experiment is dead. Twelve years after the thirteen colonies on the east coast of North America claimed independence from the most powerful empire at the time, they still did not have a constitution. It had a weak central government, without the power to tax and under the Articles of Confederation required unanimity in decision making. Yet to discount its future was a grave error.

European integration is still evolving. Integration is a process not an event.   Monetary union is an important step, but the project is incomplete. The measures Europe is taking in response to the crisis are of historic importance, even if dictated by necessity.   On the other side of the crisis, Europe will gain institutional capacity and more integrated and transparent fiscal policy. It will become more integrated, contrary to the naysayers who see disintegration on the horizon.

Consequences

Often it seems that the way one crisis is resolved creates the very conditions out of which the next crisis arises. This seems to be where Europe is headed. The dialectic between the Integrationists and Hard Money will produce a policy mix of tight monetary policy and tight fiscal policy. This policy mix condemns the euro zone to even slower growth than it had experienced before. Some observers talk about a "new normal" for the US economy of slower growth and higher unemployment. In those terms, there will be a "new normal" for the euro zone too.

Consider that during the first half of the past decade, the euro zone grew by an average pace of about 1.25% per year. The second half of the decade, it grew at a rate of about 0.75% a year. The particular settlement of this crisis risks stagnation in the euro zone as a whole. This is especially tragic because there is a demographic challenge around the corner that stronger growth would also help address.

The US economy expanded by 0.8% in the first quarter. This is what the ECB expects the euro zone to grow by for the entire year and is slightly faster than the 0.7% that the EC forecasts. To be sure, the US also faces serious fiscal challenges. And it cannot simply grow out of them as it has in the past. Even if not a panacea, positive nominal and real growth will help ease the burden and is simply better than the alternative.

Given that the euro is still considered over-valued by most econometric models (PPP, FEER and REER), both the Hard Money and the Integrationist camps are unlikely to resist in word or deed an orderly decline in the euro. Just as it has spent several years now being over-valued, policy-makers and investors should be prepared for a period of time that the euro is under-valued by those same models.

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