Has Draghi *Really Saved* The Euro?

BY DESMOND LACHMAN

The currency rests on two questionable premises.

On the second anniversary of ECB President Mario Draghi's famous "the ECB will do whatever it takes to save the euro" pronouncement, it is understandable that European policymakers appear to have convinced themselves that the worst of the European sovereign debt crisis is behind us. After all, European sovereign bond yields have now returned to their pre-crisis lows, European equity markets are buoyant, and the earlier market talk of an existential threat to the euro has long since totally receded.

Sadly, European policymakers' present complacency about the eurozone's economic future would seem to be dangerously misplaced. This is especially the case in view of the present fragile state of the European economic recovery, the rising risk of deflation, and the increased signs of political fragmentation. In that respect, European policymakers would seem to be ill-advised to be glossing over Europe's still very shaky economic and political fundamentals in general and its unsustainably high private and public sector debt levels in particular. Worse yet, they would seem to be making a gross policy misjudgment by allowing complacency to sap their willingness to persevere with those structural economic and institutional reforms that might place the euro on a more secure footing.

There can be little doubt that Draghi's July 2012 "do whatever it takes" statement did succeed in pulling the eurozone back from the brink. It did so by convincing market participants that *in extremis* the

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. He was formerly a Deputy Director in the International Monetary Fund's Policy Development and Review Department and the chief emerging market economic strategist at Salomon Smith Barney.

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www.international-economy.com
editor@international-economy.com

ECB would not allow a eurozone member country to fail and that the ECB was indeed committed to buying as many of a member country's government bonds as might be needed in order to keep that country in the euro. As a result, despite the fact that the ECB has yet to buy a single European bond under its Outright Monetary Transactions program and despite an unfavorable German Constitutional Court pronouncement against that program, the markets have come to be convinced about a "Draghi put" on the eurozone sovereign debt market that will provide an effective floor under that market.

European policymakers mistakenly ascribe most of the improvement in European market sentiment over the past two years to the ECB's actions and to their own policy efforts. They do so in seeming disregard of the markedly changed global liquidity environment. In that respect, they choose to gloss over the major assist that the ECB has received from both the Federal Reserve and the Bank of Japan. For shortly after the ECB's introduction of its OMT bond buying program, both the Fed and the Bank of Japan embarked on new rounds of massive quantitative easing on an unprecedented scale.

Over the past two years, those rounds of quantitative easing have resulted in highly favorable global liquidity conditions as underlined by an expansion of the Fed's balance sheet to its present size of over $4.25 trillion. Those favorable conditions in turn have driven a powerful global market rally across all high-risk products and have reduced market volatility to an historic low. In that context, it would seem that highly ample global liquidity conditions have also been a critical factor in the return of European bond yields to pre-crisis levels. And they have done so despite an appreciable deterioration in the debt and political fundamentals of the European economic periphery.

A striking feature of the return of European sovereign debt yields to pre-crisis levels, which should be giving European policymakers pause, is that they have occurred despite the fact that European sovereign debt levels today are considerably higher than they were before the onset of the crisis. It is also striking that the strong European debt rally has occurred despite growing signs of European political fragmentation.

It would seem that ample global liquidity conditions have blinded markets to the longer-term risks inherent in the considerable loss of political support for the European project. In particular, markets seem to have been unfazed by the fact that the May 2014 European parliamentary elections resulted in the election of as many as 30 percent of parliamentarians who are openly opposed to the Euro project. Equally puzzling is the markets' seeming unconcern about the recent very strong showing in the polls of extreme parties powerfully opposed to Europe such as Marine Le Pen's National Front in France and Alexis Tsipras' Syriza Party in Greece.

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Experience with previous favorable global liquidity environments should have taught us by now that those environments do not last forever. It should also have taught us that when liquidity is no longer ample, markets again become unforgiving of poor economic and political fundamentals. Against that background, it has to be regretted that European policymakers have not taken full advantage of the breathing space that more favorable global market conditions have afforded them to enact those structural measures that might have placed the euro on a firmer footing. Instead, they have allowed themselves to be blinded by the removal of market pressure to the acute economic and political vulnerabilities that still characterize the eurozone. Sadly, this has to heighten the risk that the eurozone will experience yet another crisis once the Federal Reserve starts the process of normalizing interest rates.

Among the eurozone's most acute economic vulnerabilities is the poor state of the public finances of its periphery. According to Eurostat, by the end of the first quarter of 2014, the public debt-to-GDP ratio had reached as high as 174 percent in Greece and more than 130 percent in Ireland, Italy, and Portugal. More troubling yet, those ratios showed little sign of stabilizing, having risen over the past year by 15 percentage points in Greece and by 5 percentage points in both Italy and Portugal.

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Further compounding matters has been the continued high private sector debt levels and the rising levels of non-performing bank loans.

One would have thought that these very high debt ratios would have shaken European policymakers out of their present state of complacency about the risks of a recurrence of the European sovereign debt crisis. This would particularly appear to be the case at a time when Europe's anemic economic recovery already appears to be running out of steam and when heightened geopolitical risks both in Ukraine and the Middle East could further undermine the economic recovery. It would also seem to be the case at a time when large product and labor market gaps are already driving Europe towards outright price and wage deflation.

In the context of little or no growth in nominal income, the countries in the European periphery will be required to generate very much higher primary budget surpluses than they are now doing if they are ever to restore public debt sustainability. However, it would seem to be far from clear whether those countries will be politically able to make such a fiscal effort at a time that their politics are fragmenting and their populations are suffering from acute austerity fatigue. It would also seem questionable whether a new round of budget austerity within the straitjacket of the euro will do much to improve the European periphery's public finances. This would especially seem to be the case considering the past tendency of such tightening to drive the periphery more deeply into recession.

In the context of Europe's shaky debt and political fundamentals, European policymakers' complacency would appear to rest on two questionable premises. The first is that global liquidity conditions will stay ample for a long period of time. The second is that should the going get bad for Europe, markets will continue to buy into the notion that the ECB will be there to backstop any member country under real financial market pressure.

If European policymakers do not move quickly, we should start bracing ourselves for another, and possibly more virulent, round of the European sovereign debt crisis once the Federal Reserve starts to raise interest rates next year.

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Sadly, all the clues seem to be pointing in the direction that both of those premises will turn out to have been very faulty. After all, the Fed has already made clear that it intends to have exited quantitative easing by October 2014 and that it stands ready to start raising interest rates once U.S. unemployment has declined to the Fed's desired level. For its part, right from the very first announcement of the ECB's bond buying program, the ECB has made it clear that it will only buy bonds of those member countries that are prepared to submit themselves to economic adjustment programs. Considering the speed with which Greece, Ireland, and Portugal have all wanted to exit their IMF programs, and considering the mounting domestic political backlash against budget austerity and structural economic reform across the European periphery, it is far from clear that the ECB will be in the position to make large-scale purchases of countries' bonds should they indeed ever come under market pressure.

With time running out, one has to hope that the ECB will move soon to aggressive quantitative easing in an effort to revitalize Europe's flagging economic recovery. One also has to hope that European policymakers redouble their efforts towards banking union and that the eurozone's surplus countries adopt an easier fiscal policy stance in an effort to provide much-needed support for the European economic periphery. For if European policymakers do not move quickly in that direction, we should start bracing ourselves for another, and possibly more virulent, round of the European sovereign debt crisis once the Federal Reserve starts to raise interest rates next year. ◆