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Western European Indicators and Insights

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ECB: To the rescue?

ECB changes its mind

Faced with the hugely added potential market turmoil that the US debt downgrade may have brought, it was no great surprise that the ECB issued a statement on Sunday evening hinting that it would now start to buy Italian and Spanish government debt. This was something that the ECB was seemingly unwilling to consider only as recently as last Thursday, when it implicitly baulked at such purchases until it saw greater fiscal consolidation efforts from the Italian and Spanish government. This decision by the ECB last week was very risky, not only because it was potentially so divisive, but because it threatened to accentuate banking sector problems within the Eurozone, that were already deepening enough to have forced the ECB last Thursday into promising further and longer bank liquidity injections.

Italy yields to pressure

However, the ECB may see its gamble as having paid off, at least in regard to Italy, where the Government there (under additional pressure from the ECB via a letter from President Trichet) has promised to bring forward the goal of a balanced budget to 2013 alongside the introduction of a constitutional balanced budget amendment, with a clearer urgency evident in a decision to recall parliament later this week so that the legislation can be enacted swiftly.

Admittedly, details of the Italian budget cuts are still far from clear, but they seem to have satisfied the ECB, the question being whether all of the Council backed the move to restart bond purchases, ie was there further resistance from Germany. It is hard to tell at this juncture, but very clearly the ECB statement implies that the central bank does not want to be in a position where it has to support the Spanish and Italian bond markets for too long, instead acting as a stop-gap until the EFSF (made more flexible at the Eurozone Summit on July 21) can enact such purchases.

ECB taking on stop-gap role

However, this stop-gap role belatedly and reluctantly taken ECB may be protracted, as a joint statement from Germany and France on Sunday notes that the parliamentary approval needed in both countries will take until the end of September. It should be noted that this mention of parliamentary approval perhaps should remind markets that domestic political agendas may yet cause more turmoil if there is the familiar resistance to bail-outs seen of late in Germany. Moreover, the statement from Germany and France makes no hint at any enlargement of the € 440 bln EFSF, something that markets had been critical of after the July 21 summit and something that had been demanded by EU President Barroso late last week (much to the chagrin of Germany).

Market reaction, mmmmmmmmm?

Regardless, the ECB action seems have worked well, with European stock markets having as yet failed to slump while Spanish and Italian (10 year) bond yields have fallen by around 80 bp. However, this merely returns Spanish and Italian bond yields back to the levels seen just after the July 21 summit, thereby still leaving question marks about the fiscal sustainability of both countries, especially amidst the further pressure on growth that added fiscal consolidation may entail. Admittedly, some attempt to restore growth was a demand by the ECB, calling for structural reforms, some of which were recognized in the measures announced by Italy. However, if there is any reason for more optimism in regard to Eurozone growth prospects, it may be indirect. Given that very clearly in Europe the rise in food and energy costs has been squeezing consumer incomes, the fall back in commodity prices that the debt crisis either side of the Atlantic has brought in its wake must be positive.

Watch for Germany

One other area for optimism is that perhaps for Germany the crisis is coming closer to home, not just in terms of its scale, but also in the fact that the hitherto resilient German economy may now be buckling given the message from

recent survey data and even the likes of official industrial production numbers. This is important as Germany has been the main source of intransigence in the manner in which the Eurozone has dealt with its debt crisis. Germany was initially resistant to any Greek bail-out, especially without penal rates attached, then was the main factor behind the private sector involvement which so incensed the ECB, it also being the major power behind the thinking which has ensured that the ECB bond purchases have all been sterilized and therefore have not been part of a QE scheme that may actually have helped the fragile Eurozone banking system over the last year. And, as suggested above, Germany is also very clearly against any enlargement of the EFSF, fearing that this could lead to the eventual creation of a Eurozone bond market. Given that the creation of Eurozone bonds may be the only realistic avenue in which (at least the Eurozone) sovereign debt problem may be resolved and the future of the euro itself secured, it will be interesting to see if the German attitude may be changing. There are signs that it may: the opposition party in the German parliament (the Social Democrats) has called on the introduction of Eurozone bonds, while the usually skeptical German media have reacted to the recent market turmoil not in the familiar rant against bail-outs but in recognizing how important the euro has been to recent German prosperity.

Time will tell. In the meantime the ECB action has bought more time, just how much being very unclear.