

## Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

AUGUST 2, 2012

### The ECB, Clogged Financial Plumbing and a Bumblebee?

Last week, European Central Bank (ECB) president Mario Draghi spoke boldly; after declaring the euro “irreversible,” he remarked, “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro, and believe me, it will be enough.”

Many interpreted Draghi’s remarks (made at an investment conference in London) as a signal for imminent open market purchases. The supposed target of these purchases: peripheral government bonds. The ostensible purpose: shore up confidence in euro area debt markets and the common currency. For investors, these were warming thoughts.

#### Talk Is Cheap

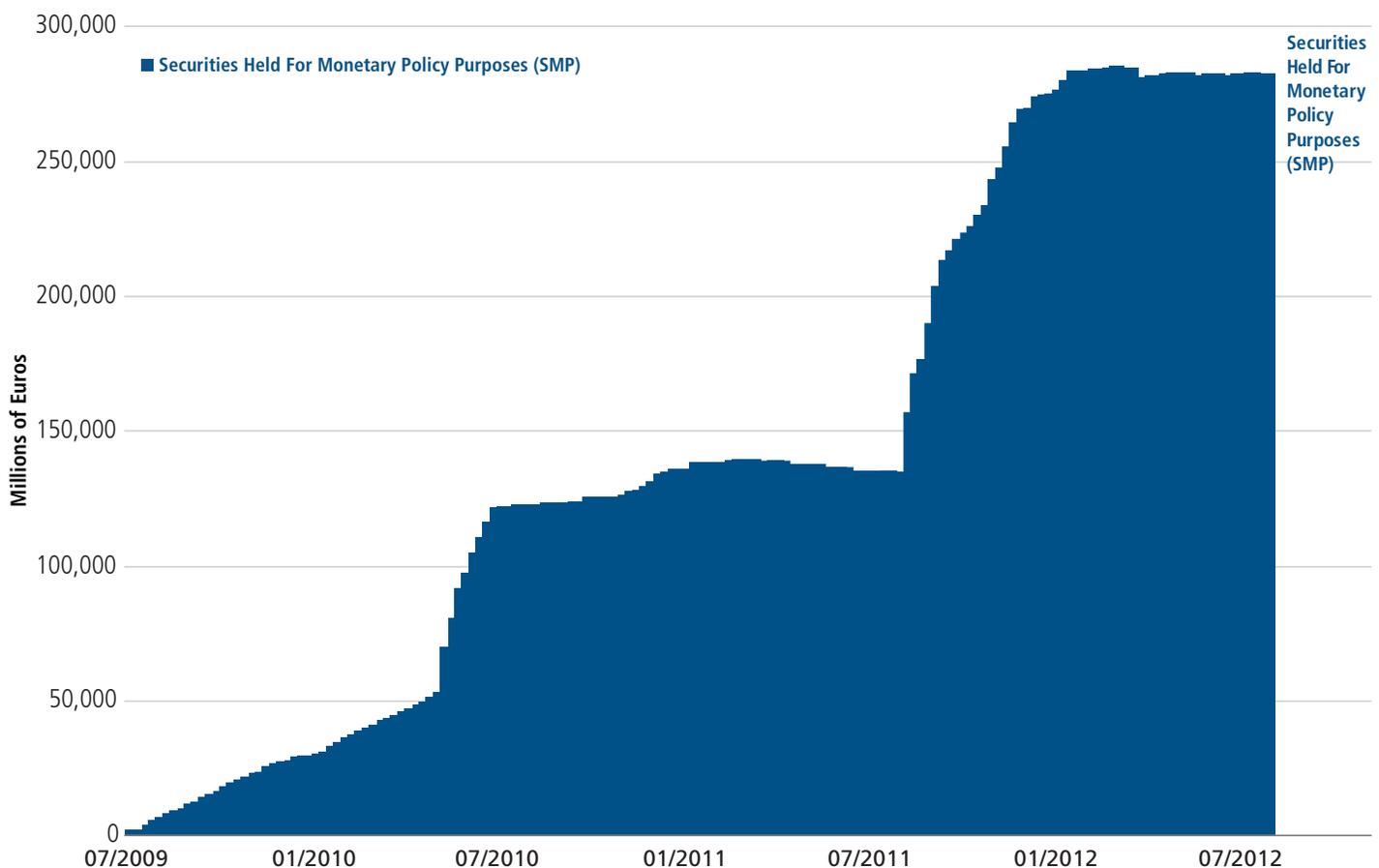
But, we say, talk is cheap. The ECB’s Securities Market Programme (SMP) is, and has been available to purchase sovereign debt. Despite the availability, SMP holdings flat lined at EUR280 billion in December 2011 (*see Chart below*).

What’s more, the ECB failed to announce any policy changes at today’s Governing Council meeting in Frankfurt.

At the press conference after today’s meeting, Draghi hinted that open market purchases “may” be reactivated and that the “front end” of the market would be targeted. Draghi further noted in the Q&A that any ECB bond-buying actions would be in concert with the ESM/EFSF (“conditionality is essential”) and that the German Bundesbank still opposed further bond buying.

With expectations of the ECB buying in the short end of euro area bond markets, Spanish and Italian yield curves steepened, as the difference in yield between Italian 2s and Italian 10s jumped +65 bps on the day (yields on 2-year government bonds *fell* to 3.74% while yields on 10s *jumped* to 6.33%). The EUR/USD tumbled back to \$1.21 and the S&P500 dipped.

ECB BOND PURCHASE PROGRAM “ON HIATUS” SINCE DECEMBER



Source: European Central Bank

Clearly this was a letdown to the market after last week's heightened expectations. What is going on?

### Clogged Financial Plumbing

Based on Draghi's speech last week, we think "financial fragmentation" worries Mr. Draghi most. As illustrated in the **Chart below** despite the ECB's recent initiatives, easier monetary policy has not been transmitted evenly to borrowers across countries. For example, interest rates on new, nonfinancial loans to firms fell in Germany year-to-date, while comparable interest rates in Spain and Italy marched higher.

Why? Mr. Draghi argued that because the "interbank market is not functioning" and sovereign risk "premia" remain high, interest rates across euro area countries no longer move together. As Draghi insisted, "to the extent that these sovereign premia hamper the functioning of the monetary policy transmission channel, they come within our mandate."

Where he must be diplomatic, we will be more direct: sovereign debt is used as collateral in borrowing by banks and non-banks. The smooth functioning of this market circulates money and credit. If market participants discriminate among different kinds of collateral the transmission mechanism for policy fails. In our view, regardless of whether the ECB SMP, ESM/EFSF, a new longer-term refinancing operation (LTRO) or some combination of these vehicles arrive to address the problem, this is the clog in the financial plumbing that must be fixed.

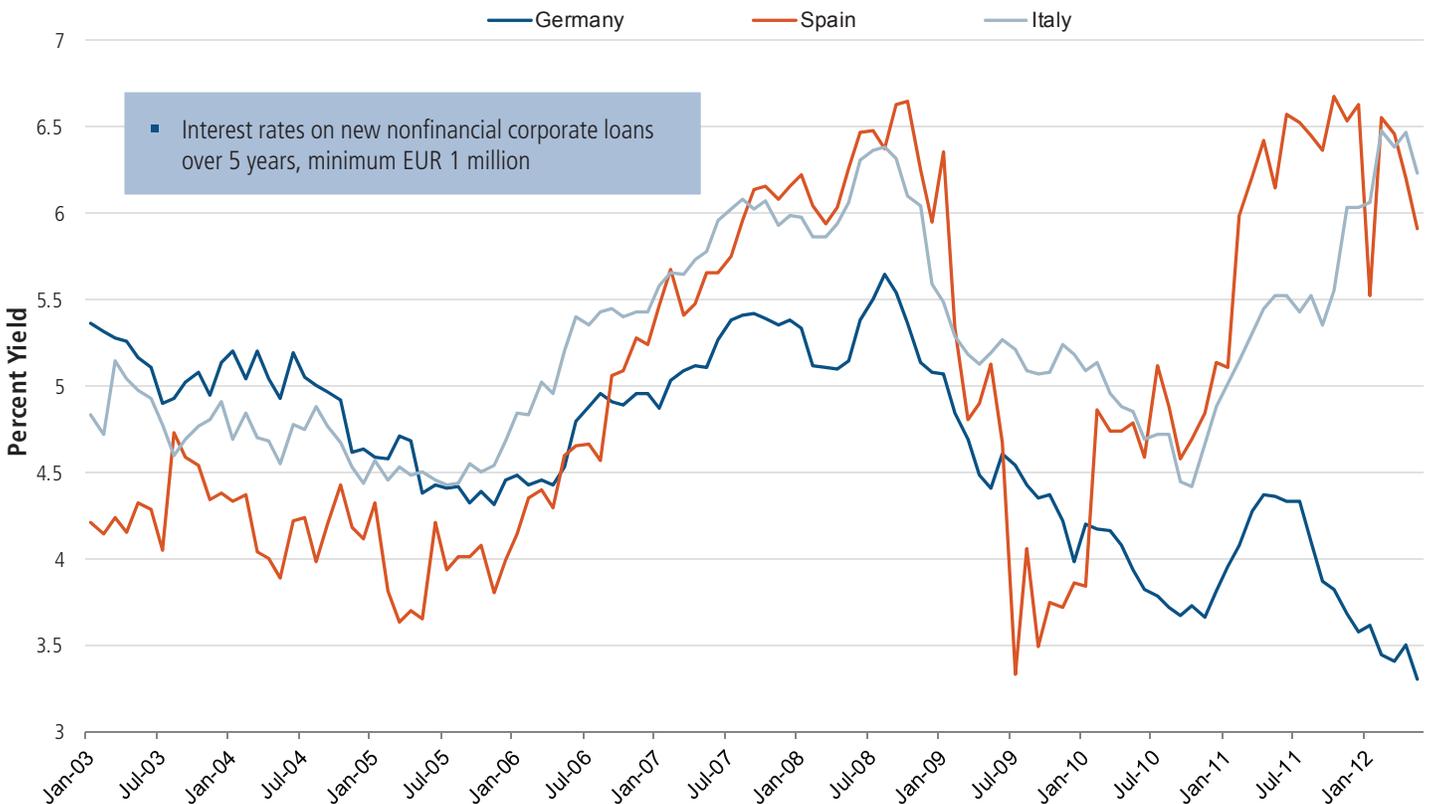
Time is of the essence: with the financial system clogged, bank lending and economic activity continue to suffer. This week's data on manufacturing activity and unemployment (euro area record high) point to a worsening economic picture.

### Words Versus Actions

In Draghi's view (espoused twice now), the clog results from market participants questioning the "reversibility" of the euro. To challenge market perception, Draghi counters with words and declared the euro "irreversible". Markets seem unconvinced. So long as market participants prefer a German bund to a Spanish bono, doubts about the euro's future will persist.

Much to our surprise, last week's press accounts definitively ignored some choice introductory remarks in Draghi's London speech where the ECB chief likened the euro to a bumblebee. Why a bumblebee? Because, in his words, "a bumblebee is a mystery of nature because it shouldn't fly but instead it does." In order to continue to fly, the euro must "graduate to a real bee." His comments and today's press conference reaffirm the ECB's commitment to support the euro but still do not provide concrete steps on how to make the bee fly.

## ECB MONETARY POLICY TRANSMISSION MECHANISM CLOGGED



Source: European Central Bank