STEIN BROTHERS
LONDON-STOCKHOLM

Europe's game of *pollo*

ECB policy increases, not decreases, break-up risk

Markets welcomed the ECB's announcement of potentially unlimited Outright Monetary Transactions (OMT) in early September. However, in the last few days, Spanish and Italian bond yields have stopped falling and (in the case of Spanish) begun to edge up again. Not much, but the mere fact that they are rising should be a concern for euro area (EA) decision makers. There can be a variety of reasons for this, but one is likely to be the game of chicken currently being played out in the EA.

The Governor of the Central Bank of Cyprus, Mr Demetriades, has said that the mere threat of OMT is enough and that the ECB may not have to buy any bonds at all. He is almost certainly wrong. In fact, the success of the OMT is much more likely to be dependent on a request for assistance (probably from Spain) followed by visible action. We have been told that OMT will only come with conditionality. However, no potential beneficiary (read: Italy or Spain) of OMT wants conditionality. Ideally, and unsurprisingly, governments would prefer the ECB to intervene with unlimited amounts to support their bonds without having to submit to unpleasant and humiliating conditions. This is of course anathema to Germany as well as to the ECB Governing Council (at least for the time being). But, in the absence of any active OMT, we are back to square one, with no reason for markets to do other than widen spreads again as conditions fail to improve.

Hence the current game of chicken being played out in the EA. Both the Spanish and the Italian governments have repeatedly made it clear that they do not intend to apply for assistance, not even under the 'conditionality light' variant outlined by Mr Draghi. On the side-lines, the French government wants Spain to apply for a bail-out and thus benefit from OMT; while the German government is equally opposed. Members of the ECB Governing Council are also taking part in the debate, with, eg, Mr Coene, Governor of the National Bank of Belgium, saying that he expects the Spanish government to have to apply for a bail-out. And so on.

The Spanish and Italian governments presumably expect that, should market conditions again deteriorate, the ECB will have no choice but to step in unconditionally (or with even lighter conditions) if it wishes to preserve the euro. The ECB for its part insists that it will do no such thing. Both sides are seemingly waiting for the other to blink. In this game, the Spanish and Italian governments have one advantage: the ECB has blinked before. It is by now difficult to remember all the red lines that the ECB has abandoned over the past four years, but another one was ditched on 6th September when the minimum credit rating threshold for collateral was abolished. But, on the other hand, within the creditor countries, notably now also in Germany, the opposition to bail-outs and debt monetisation continues to rise. Mr Weidmann is not resigning yet; but whether he could remain in his post if the next ECB 'blink' meant OMT without conditionality, is highly doubtful. Moreover, any attempt to introduce OMT without conditions would almost certainly see another recourse to the German Constitutional Court.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

In fact, the ECB's policy actually could make another crisis more likely than not. Impressed though markets were with the original announcement of the OMT, they are becoming increasingly unimpressed in the absence of action. Spreads will widen again, certainly so at the slightest sign of public finances and/or growth deteriorating. But if governments refuse to accept conditionality and the ECB eventually is anyway pushed into undertaking its unlimited bond buying in order to save the euro, the already strong resentment will grow in creditor countries; *per contra* if there is no OMT without conditionality and conditions deteriorate sufficiently in debtor countries to force them to apply for help, resentment grows there instead. In either case, pressure builds up. Further, the longer Spain (and possibly Italy) wait before applying for a bail-out, the worse their public finances become, meaning that the eventual package will have to be bigger than would today be necessary. Cue further resentment.

Meanwhile, the ECB's policy also necessitates a tougher attitude towards governments that have already received assistance, lest government needing bail-outs in the future come to believe that they can sign up to whatever is being asked, only to then abandon their targets/commitments after some time has passed. This partly explains the continued stern attitude towards the constant Greek requests for easier terms, whether in time or in cost.

I am, as most of you know, on the record as having said since early 2011 that the likelihood of Greece being out of the euro before the end of 2012 is somewhere in the region of 98%. This to my mind remains the most likely scenario, even though time is getting short and I may get the timing wrong. But the ECB's policy – which of course is undertaken with the best of euro-preserving intentions – could cause a crisis to be triggered somewhere else first.

Gabriel Stein
gabriel.stein@steinbrothers.co.uk

Gabriel Stein is Managing Director of Stein Brothers (UK) Ltd and Chief Economic Advisor to OMFIF. The views expressed are his own.