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EUROPE • FINANCE

Ireland points way for Cyprus and euro periphery

Europe badly needs some good news to reverse the recent negative outlook revisions. Reports over the past few weeks have been rather bearish. The European Commission and lately the European Central Bank have downgraded their growth forecasts for the whole eurozone over the next two years. The Italian election results have made it even harder to govern the country for the coming weeks and months, which is likely to further discourage consumption and investment. The Cyprus bailout plan may lead to renewed contagion in peripheral countries.

Financial markets' reaction to this negative news has been rather subdued. There may be several explanations. A first is that some market participants are still recovering from the losses incurred last year from shorting the euro, as they underestimated European authorities' survival capacity. They may have become much more prudent before running the same strategy again. A second explanation is that market participants may believe that countries have already done their homework, and that sooner or later underlying economic conditions will improve as a result of the budgetary measures and structural reforms implemented so far. A third explanation is that markets have been impressed by how powerful the ECB's announcement to do "whatever it takes" has been in taking away tail risk.

The key question is how long these explanations will hold, especially if further negative news will flow from the euro area. Several factors may lead to a substantial reassessment of risk.

First, in an environment of low interest rates around the world, the search for yield may fuel renewed speculative position-taking, aimed at shorting peripheral euro countries' debt. Second, new negative reports about the eurozone economy, especially in the periphery, might show that the reform

agenda is far from being completed, and much more is required in order to strengthen growth potential and put the debt-to-gross domestic product ratio on a credible downward path. Third, in order to benefit from the “outright monetary transactions” provided by the ECB, countries have to apply for a programme, while still being able to fund themselves in the market. The set of countries currently meeting such conditions is empty. Greece, Ireland and Portugal all have a programme but lost market access. Spain and Italy still have market access but have so far refused to request an adjustment programme, as national pride seems to be valued more than the pain endured by the respective economies in facing high lending rates and a credit crunch. Both countries are unlikely to apply as long as financial markets remain complacent. Furthermore, any request for a programme has to be accepted by all the other eurozone governments. The Cyprus bailout has shown how difficult it will be to get an agreement until the German elections are over.

The ECB’s bazooka has worked so far, in calming the markets, even without being used. That is the ideal scenario. However, the bazooka might have to be used at some point, to fully convince those who may think that it is only a threat, with no real ammunition. Using the bazooka is not without costs, however, especially for the reputation of the central bank. The best way to convince sceptics may be to aim at an easy target, that cannot be missed, and ensure lasting success. Waiting for a much bigger target to get close enough might be more risky and fuel instability.

Looking closely to the eurozone there might be some easy target to aim at, which would reassure that the bazooka functions well and is able to hit even bigger targets if needed. Ireland has been the greatest and more consistent source of good news over the last year. Government bond yields have fallen dramatically, even before last summer’s ECB “whatever it takes” announcement. Ireland is the only crisis country whose current account moved back to surplus since 2010, and further improved since, thanks to the highest trade balance in the euro area (24 per cent of GDP). Competitiveness has been boosted by structural reforms and falling labour costs (-15 per cent compared to 2008). The budget deficit is still high (7.7 per cent of GDP), but has come down 6 percentage points in 2012, faster than expected, and is projected to fall further over the next two years. The debt/GDP ratio is projected to stabilise at 122 per cent in the course of this year.

Fiscal policy has been on a severely restrictive path for almost three years. Textbook analysis suggests that the success of such a strategy depends on it being accompanied by a very accommodating monetary policy. This is not the case in Ireland, because the monetary policy transmission mechanism remains impaired, as a result of the sovereign debt crisis and the ailing financial system. Bank credit to households and companies continues to fall and lending rates remain high. Tight monetary conditions increase the burden of adjustment for fiscal policy.

Ireland should benefit from the OMT, but it cannot. Indeed, one of the conditions which have been set for being eligible to the OMT, in addition to having an adjustment programme, is the ability of the sovereign to finance itself in the markets. This is not a very precise criterion to measure, especially for a small economy which by definition has a less liquid bond market than the benchmarks. Substantial progress has been achieved recently. Ireland has issued medium-term bonds at rates lower than those of Italy and Spain, through a syndicate deal. Some Irish banks have issued non-guaranteed bonds. There may still be some way to go for Ireland to be considered as having fully recovered market access, but the direction is right and the remaining gap may be smaller than many think.

European authorities can follow two type of strategies going forward. The first is to stand aside and observe the progress achieved by Ireland, offering no helping hand, and defining. Market access may ultimately be defined in such a way that it is achieved when there is no need any more for activating the OMT. Ireland could probably make it on its own, but that route could be quite costly, and the risk of renewed contagion cannot be excluded.

The alternative strategy is to consider Ireland as the canary in the coal mine. It shows that there is air and light at the end of the tunnel, after several years of painful budgetary adjustment and structural reforms. The quicker the country graduates, and becomes eligible for the bazooka, the less likely the bazooka will have to be used and the greater the positive contagion to the rest of the system.

Being risk averse, European policy makers may be tempted to opt for the first strategy. They should not be surprised then if citizens around the continent increasingly associate Europe with austerity and are attracted by populist arguments against the single currency.

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