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Too Few Good Men

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Donald Luskin and Lorcan Roche Kelly

Trichet almost admits his mistake, Obama repeats his, and Bernanke maintains course.

Global stock markets are lower as of this writing, in the wake of speeches yesterday by the three most important policy-makers on the planet -- Jean-Claude Trichet, Ben Bernanke and Barack Obama. We call them "policy-makers" because, with the possible exception of Bernanke, we can't call them leaders. We think the present collapse of confidence in sovereign debt -- and indeed the general retreat of the "animal spirits" that are necessary for growth -- is due in large part to their failures of leadership. Markets hang on their every word, hoping that they will do the right thing -- but fearing that they won't, or in fact that they will do the wrong thing.

ECB President Jean-Claude Trichet did very much the wrong thing in April when he began a tragically ill-advised anti-growth rate-hiking cycle (see "EUicide" April 7, 2011). Thankfully, yesterday, as we and everyone in the market expected (see "CHooF!" September 6, 2011), he left rates unchanged. Indeed, he opened the door to future easing -- by offering what amounts to an admission of error disguised as an aggressive defense of his track record.

- At the press conference following the rate decision, Trichet announced a change in the ECB's outlook, saying the growth risks are now on the downside, with inflation risks moderating.
- The latest ECB staff projections, on which the ECB bases its monetary policy decisions, shows reduced growth outlook for 2011 and 2012 when compared with their June projections.
- We expect that this change in outlook will mean that the ECB will cut rates before the end of the year.
- The ECB will continue all "non-standard" liquidity operations. Trichet said that Euro area banks hold €13 trillion of assets that are eligible for liquidity operations, with the outstanding use of the ECB liquidity facilities in the region of €500 billion, leaving plenty of room for banks to make further use of ECB facilities (see the chart on the following page).

This was Trichet's second to last monetary policy press conference as governor of the ECB, and his last in Frankfurt. Perhaps he had an eye to his legacy, or perhaps he felt he had to defend the massive policy mistake he made earlier in the year. Whatever the reason, the most memorable

Update to strategic view

ECB, EUROPE MACRO, US FED, US MACRO: Trichet's impassioned self-defense was in fact an apology, and signals that the ECB will ease by the end of the year -- and Stark's resignation confirms it. Perhaps it will come as soon as next month. Bernanke's speech should be understood as leaving the Fed on hold unless the economy worsens. Obama's jobs speech contained precious little pro-growth potential, but at least it is a much-needed shift in the debate toward growth.

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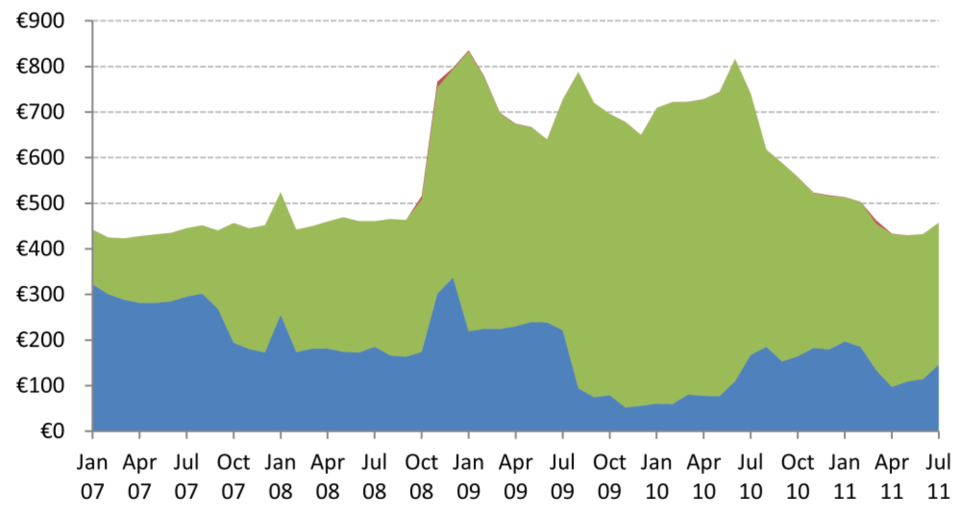
ECB ■ **Main refinancing operations** ■ **Long-term refinancing operations** ■ **Marginal lending facility** EUR billions



Source: ECB

interaction at the press conference was the usually reserved Trichet's very forceful defense of his and the ECB's record. It came as something of a *non sequitur*, in answer to a question on ongoing German membership of the currency union.

We urge you to watch it on video (it starts at 49:20). You will probably be reminded, as we and others were, of the famous scene from the film *A Few Good Men*, in which a Marine colonel played by Jack Nicholson gives a passionate defense of the necessary, yet unsavory, duty performed by the military. But for Trichet, as for Nicholson's Colonel Jessep, it is a case of protesting too much -- a form of obfuscation to avoid admitting two great policy mistakes -- the rate rises in April and July this year, and last month's disingenuous and too-little-too-late dithering over support for Italy against speculative attack (see "On Europe's July Rate Decisions" July 7, 2011).

For all his defense -- well earned, to a fault -- of the ECB's inflation-fighting record, it is these monetary policy mistakes that will seal Trichet's legacy. He has only one more meeting to chair, which is to be held in Berlin -- the very heart of German conservatism. If Trichet choses to cut interest rates there, it may go some way towards restoring his damaged reputation, while strongly asserting the ECB's independence under his presidency. But, as Trichet has learned, the road to hell is paved with bad interventions. He may leave the coming rate cut to his successor, the Italian Mario Draghi, whose tenure starts in November.

- Regardless of the time or place, the path is clear. The ECB is going to have to ease -- thus the sharp euro weakness in the aftermath of the press conference. But this is a *good* form of euro weakness, not the scary risk-off signal we've come to expect over the last several months of sovereign debt crisis. It's the long-awaited fulfillment of

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what we predicted in April -- that the misguided tightening cycle would ultimately weaken, not strengthen, the euro (again, see "EUicide").

- The ECB's likely easing was confirmed today with the resignation of German hawk Jürgen Stark. Stark was due to remain on the governing council until 2014, and is reportedly resigning due to a conflict over the expansion of the ECB's Securities Markets Programme (SMP).
- Stark follows in the footsteps of Axel Weber, who stepped down as head of the Bundesdbank earlier this year for similar reasons (see "The Libyan Connection" February 22, 2011).
- Nevertheless, the Stark news has come as a surprise to the market, with the euro losing over a cent against the dollar, bringing it firmly outside its recent range, and down to levels not seen since February. We see this as a good thing -- the ECB *must* ease and the euro *must* fall. But at the moment, markets seem to be focusing on the political instability implied by Stark's move.
- Note that while the traditions of the FOMC permit dissenting votes, the ECB Governing Council insists on unanimity. The only way to dissent is to resign.

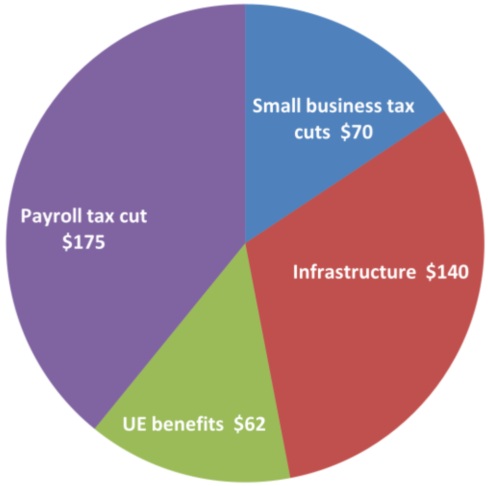
Ben Bernanke's eagerly awaited speech yesterday, by contrast to Trichet's, was a masterpiece of just the kind of quiet and certain leadership markets and the economy really need now -- infused with the courage to do nothing when there's really nothing to be done, and even a touch of humor (on video, it starts at 15:57).

- Pundits continue to insist that the Fed is gearing up for more easing, and interpret even Bernanke's denials -- implicit by pretty much omitting the topic yesterday -- as confirmation.
- However, continue to take Bernanke at his word -- or lack of words. We continue to believe that unless the unemployment rate rises and/or inflation falls, the Bernanke regards today's policy posture as just about perfect (see "On Bernanke at Jackson Hole" August 26, 2011).

Barack Obama's much-ballyhooed jobs speech last night, on the other hand, was just the opposite -- a vast and politicized agenda of "do something," when the whole problem is that the government has already done too much, and too much of the wrong thing (see the chart on the following page).

- Nothing specific was said about how the $447 billion in proposals would be paid for -- only that they would be. But the general idea is clear enough: "we should raise taxes on those who are most fortunate and can best afford it."
- Obama claims that "the vast majority of wealthy Americans and CEOs are willing to do just that if it helps the economy grow." But we know this isn't true, or they would already be voluntarily contributing. We do not believe that they regard themselves as "fortunate," but rather as hard-working and risk-taking. And we

Proposed American Jobs Act USD billions



Source: White House

don't think they believe being taxed more would "help the economy grow." Indeed, the ever-present threat, repeated at every chance by Obama, that their wealth will be confiscated we think is the single biggest barrier to growth, and hence to job creation.

- The other great barrier is the structure of perverse incentives that discourage work. Obama's proposals include extending unemployment benefits yet again -- perpetuating the incentives that have made this the jobless recovery from hell. What's worse, they deepen the problem by creating new perverse incentives to work only part-time through so-called "job sharing" -- and for long-unemployed persons to enjoy a form of affirmative action in hiring decisions, making it an advantage to be without a job for the longest possible time.

We see this initiative as mostly a political gesture, designed to shame Republicans who sensibly block enactment of these proposals over the coming months. We think it will have the opposite effect -- that it will give the opportunity for a not very impressive field of GOP presidential hopefuls the chance to articulate their pro-growth agendas. Perhaps it will be helpful to the national mood to at least focus debate on growth -- after months of dangerous brinksmanship over austerity, this would be a most salutary change of subject.

Bottom line

Trichet's impassioned self-defense was in fact an apology, and signals that the ECB will ease by the end of the year -- and Stark's resignation confirms it. Perhaps it will come as soon as next month. Bernanke's speech should be understood as leaving the Fed on hold unless the economy worsens. Obama's jobs speech contained precious little pro-growth potential, but at least it is a much-needed shift in the debate toward growth.