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MACROCOSM

Unquestionable Success?

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The worst thing that can happen to Europe now is that everything goes perfectly.

At the press conference following yesterday's completely expected European Central Bank decision to maintain interest rates unchanged, President Mario Draghi declared the 3-year Longer-Term Refinancing Operations an "unquestionable success."

Our view for the past few months (see, among many, "Europe's Wall of Liquidity" December 21, 2011) has been very bullish on the 3-year LTROs, so it may seem churlish of us to now question the "unquestionable." But the reality is that the tactical success of the 3-year LTROs -- as great as it is-- does lead to risks in strategic space that are worthy of highlighting.

- The reaction of European politicians and policy makers to the euro crisis has been a mixture of fire-fighting -- the short-term fix -- and structural reform and integration -- the long-term sustainable steady-state. The 3-year LTRO is part of the fire-fighting. The moves towards reform and integration -- the only durable solution to the euro area crisis -- have been driven by the *force majeure* that is the crisis. The risk now is that with the crisis atmosphere having calmed down, there is less incentive for reform and integration.

Last August, French President Nicolas Sarkozy and German Chancellor Angela Merkel laid out the reform/integration solution to the euro crisis (see "Two-Tier Europe is Born" August 17, 2011). The major hold-out against their vision in European political space was Italian President Silvio Berlusconi. With his removal -- made possible only by the crisis of a drastic loss of confidence by bond investors -- and the appointment of Mario Monti's technocratic government, the moves towards integration and structural reform gathered pace.

On a euro area level, the move towards integration can be seen through the Fiscal Compact signed at the euro area leaders meeting on March 2 (this agreement still has to be ratified at the national level across the euro area). Under the compact, countries that ratify have to agree to budget controls embedded in their constitutions. This is the start of euro area oversight of national budgets.

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: Mario Draghi rightly called the 3-year LTROs an "unquestionable success." From here, it's hard to see how sovereign yields could improve much more. However, the risk to continued reform and integration in the euro area is heightened due to that success. Politicians who are not kept under pressure are less likely to reform growth-averse economies, or cede sovereignty for the sake of integration. For markets in 2012, the risk is that Germany, France and the ECB will take dangerous steps to put the pressure back on.

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The strict controls on spending required under the compact have to be met with "austerity" programs in peripheral euro area countries. Except in Greece, this so-called "austerity" is dominated by pro-growth structural reforms to labor and product markets and social safety nets, similar to the reforms made by Germany in the mid-2000's (see "Europe's Supply-Side Revolution" February 17, 2012).

- The kind of pro-growth austerity that is being implemented can work for Europe -- it has made Germany into to most dynamic developed economy. But political will is required to drive through measures that damage vested interests, increase efficiencies, and unwind some of the greatest excesses of socialist Europe.
- This political will is strongest when the pressure on politicians is the most severe. The dangerous balancing act in the second half of 2011 was to use the bond market to keep politicians under enough pressure to start to implement serious reforms, but not under so much pressure that they would chose to leave the euro area (see "Papandemonium!" November 3, 2011).
- The "unquestionable success" of the 3-year LTROs risks tilting the balance too far in the opposite direction -- that is, taking the pressure off. Already, the LTROs' effect on Italian bond yields has been spectacular. Indeed, for now, it's hard to see how sovereign yields in Europe could improve much from here. Too much pressure may be bad, but not enough pressure may be worse.

Yes, Monti in Italy and Rajoy in Spain are popular right now, and reform moves apace. But perhaps politicians who think their nations' fiscal footing is secure for at least the current electoral term -- and there are few politicians who think further than that -- will succumb to the blandishments of entrenched interests and work to slow down the reforms. A slowdown in the pace of reform and integration of the euro area will mean the past two years of euro crisis -- and the gift of time conferred by the LTROs -- will have been wasted. In that case, it will just be a matter of time till crisis reemerges.

The leaders of Germany and France -- and the ECB, now a fully-vested political force in Europe -- will be sensitive to this. If they see resolve for reform and integration slipping, they may choose to once again use the weapon of the markets to enforce discipline. They could do this by causing Spain's and Italy's bond yields to jump -- either by dumping the bonds held by the ECB in the Securities Markets Programme, or by raising the specter of contagion by threatening to delay bailout payments to Greece, Portugal or Ireland.

Yes, last year's systemic threat from Europe is off the table. But Europe won't necessarily be out of the headlines. If it becomes necessary to up the pressure for reform and integration, it will at least seem as though the ghosts of 2011 are rising from their graves. Ideally, upping the pressure will work, and reform and integration can proceed. But this is a very risky process, involving politicians trying to control for their purposes one of the most unpredictable forces in the universe -- markets.

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Bottom line

Mario Draghi rightly called the 3-year LTROs an "unquestionable success." From here, it's hard to see how sovereign yields could improve much more. However, the risk to continued reform and integration in the euro area is heightened due to that success. Politicians who are not kept under pressure are less likely to reform growth-averse economies, or cede sovereignty for the sake of integration. For markets in 2012, the risk is that Germany, France and the ECB will take dangerous steps to put the pressure back on.