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MACROCOSM

Europe Beyond Draghi's Promised Land

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Lorcan Roche Kelly

The ECB delivered, and the German court didn't interfere. But the euro crisis isn't over.

As we expected (see "On the September ECB Policy Decision" September 6, 2012), yesterday the German constitutional court gave a "yes, but" green light to the permanent European Stability Mechanism (ESM), the successor to the temporary European Financial Stability Facility (EFSF). The "but" is Bundestag oversight of any ESM programs, and any extension of Germany's commitment to the fund requiring a parliamentary vote.

This decision, coupled with Mario Draghi's groundbreaking moves at the ECB last week (again, see "On the September ECB Policy Decision") -- restated in today's ECB monthly report including vivid illustrations of the currently broken monetary policy transmission mechanism -- mean that institutions in the Euro area have done much in the last week to take euro tail risks off the table.

This risk reduction has been reflected -- as we predicted (see "Exceptional Measures" August 29, 2012) -- in falling peripheral sovereign bond yields, with euro area financials rallying and the euro currency itself strengthening considerably. That the currency has defied conventional intuition, and strengthened so much in the past week -- moving from 1.25 the day before the ECB meeting to 1.29 today -- speaks to the existential crisis of confidence that has dominated the euro exchange rate. Normally a central bank promise to engage in further easing -- and all talk about sterilization aside, the OMT *will* expand the ECB's balance sheet -- would be expected to lead to a weaker currency. In the ECB's case a promise to expand its balance sheet has led to the opposite effect, which can only mean that Draghi's assessment of "convertibility risk" -- his polite term for "euro break-up risk" -- was accurate.

Does all this mean that the euro crisis is a thing of the past? Unfortunately, no. It just means that the recent crisis phase has passed and we now have to concern ourselves with the coming phase, which will be political.

- Yesterday José Manuel Barroso, president of the European Commission -- the executive body of the 27 member European Union -- gave his annual state of the union address to the European Parliament. Barroso called for the next stage of European integration, what he called a "decisive deal for Europe."

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE FINANCIAL STOCKS: The euro crisis has abated. ECB action coupled with German constitutional court approval of the ESM means that, for the moment, risks emanating from the euro area will weigh less on investors. Peripheral yields should stabilize, safe-have German and French yields should rise a bit, and financial stocks should challenge the February post-LTRO highs. But in order to move on from here, Europe will need a new round of treaty negotiations, which will start in October. These negotiations will set the template for a federal European Union, and negotiating them will be fraught, politically noisy affairs.

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- Part of his proposal is an ambitious target of moving the European Union towards a federation of states. The founding of this federation -- which has long been the ambition of European leaders -- will require that most dangerous of European negotiations -- a new treaty.
- Previous treaty negotiations, whether it was Nice, Maastricht or Lisbon have been long and tortuous with final ratification -- like any future treaty -- requiring a round of national referenda or parliamentary votes that all would be individual event risks.

While we are still a long way from the start of negotiations, the groundwork has already started.

- Yesterday the Commission published proposals for a single supervisory mechanism for European banks.
- These would install the ECB as supervisor for euro area banks, with the possibility of it also acting as supervisor of non-euro area EU banks.
- The Commission has also published a paper on completing the economic and monetary union for the euro area covering financial, budgetary, economic and political union.
- These documents will be discussed at the European leaders' summit on October 18-19, with that meeting expected to propose a timetable for integration.

The euro project has reached the limit of what can be achieved under the current treaties. The round of negotiations that are starting, if successful, will lead to a federal Europe. However, past experience has shown that negotiations can only produce the least movement forward that is necessary to preserve the system. Without the "quantum leap" forward in integration that the ECB has been calling for, Europe will remain ill-equipped to politically respond to crises.

This is taking a longer-term view. For now, politicians in Europe can take heart from the results of yesterday's Dutch national elections, which saw a resounding victory for pro-Europe parties, with nationalist anti-euro Geert Wilders' party among the biggest losers.

In markets, which work on a much shorter timeframe than European politics, we expect peripheral yields to stabilize around their current prices over the coming weeks, with some further weakness in German and French debt. The rally in financial stocks -- despite the recent rapid rise -- still has yet to reach the levels achieved after the second LTRO last February. So barring any unexpected -- and unlikely -- adverse news, it should continue.

Bottom line

The euro crisis has abated. ECB action coupled with German constitutional court approval of the ESM means that, for the moment, risks emanating from the euro area will weigh less on investors. Peripheral yields should

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