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MACROCOSM

Whatever It Takes Turns Two

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Donald Luskin

The greatest central bank intervention that was never made -- it ended the end of the world.

Tomorrow will mark the second anniversary of ECB President Mario Draghi's speech in London -- improvised remarks, actually -- in which he declared, "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

It turned out that "whatever it takes" was nothing at all. Subsequently the ECB announced its Outright Monetary Transactions program, in which it would be a standby buyer of distressed euro area sovereign debt. But no such transactions have ever taken place. The promise of them was "enough."

- Since Draghi's remarks, 10-year sovereign yields in Italy have fallen from 6.70% to 2.73% today, and Spanish yields from 7.75% to 2.56% (as we predicted at the time: see "On Draghi in London" July 26, 2012).
- At the same time, the US Treasury 10-year yield has risen from 1.38% -- the lowest in the history of the United States -- to 2.51% today.
- *That the yields of the developed world's most risky and least risky sovereigns have converged in this way -- from initial positions of such extremity -- is proof that Draghi was facing an epic financial crisis of global scope, and that his entirely verbal intervention prevented it.*
- *By eliminating the risk of the break-up of the euro currency, Draghi ended the era of financial contagion -- and laid the cornerstone for the gradual restoration of confidence that makes economic recovery and growth possible.*
- Since Draghi's intervention, there have been crises which, if they had occurred prior, would have induced waves of global financial contagion. It wasn't so long ago that difficulties in tiny nations like Greece brought the world economy to the brink of panic. But after Draghi, similar threats such as the collapse of the Cypriot banks in 2013 and the default of Espirito Santo this year -- and the near-death experience with US Treasury default during the 2013 federal government shutdown -- barely caused a ripple in global markets.
- *Draghi's securing the euro currency eliminated a massive and critical fragility in the global economy -- the big scary domino out there, just waiting to fall.* With the euro secure, the world no longer

Update to strategic view

ECB, EUROPE MACRO, FX, US MACRO, US FED: Two years ago Draghi promised to do "whatever it takes to preserve the euro." He didn't have to do anything, but his promise saved the currency just as Geithner's 2009 commitment to recapitalize US banks saved them without any actual capital injections. The Yellen Fed is using this principle in its blanket stand-by commitment to keep rates below normal when employment and inflation are at "mandate consistent levels." This restores confidence in the economy and in government institutions, and is a platform for better global growth.

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had to fear that a little bad thing happening *somewhere* necessarily meant that big bad things would happen *everywhere*.

Draghi's elegant intervention -- which promised everything but had to actually do nothing -- suggests that the authorities do best to help market stability when they say the most and do the least.

- The US banking crisis ended definitively -- after billions of dollars had been wasted in TARP payments -- only when, in February 2009, Treasury Secretary Tim Geithner made a standby commitment not unlike Draghi's.
- Rather than forcing banks to accept small *ad hoc* federal debt capital injections whether they needed them or not, as his predecessor Henry Paulson had done, Geithner announced that the Treasury would stand by to inject equity capital convertible at near then-current stock prices.
- *By offering what amounted to a free put option under all US bank stock prices, Geithner ended the ruinous self-perpetuating cascade of bank shareholder dilution. As with Draghi, since promising to inject equity capital in this way, the US has never had to do so. The promise was enough.*

The Fed under new chair Janet Yellen is proceeding admirably under this principle. It is wisely decommissioning the unnecessary and ineffective throw-money-at-the-problem program that is QE3. And it has replaced it with a purely verbal intervention -- the commitment to keep interest rates below normal even after inflation and employment return to "mandate-consistent levels" (see "It's Yellen's World, and We're Just Living In It" June 18, 2014).

These far-reaching verbal interventions restore confidence in two ways.

- By giving an unambiguous commitment to intervene as lender of last resort, they eliminate fears of self-feeding fire sales, quelling the panic that is the necessary fuel for such vicious cycles.
- But just as important they create confidence in the very institutions that make these verbal interventions. By moving them beyond unpredictable *ad hoc* rescues and failures to rescue, they eliminate the crippling regime uncertainty that characterized the worst moments of the crisis years.

We continue to believe that this restoration of confidence represents a critical inflection point in the global economy, pointing the way out of the morass of "the new normal" and back toward growth rates and growth levels more like past business cycles (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).

Bottom line

Two years ago Draghi promised to do "whatever it takes to preserve the euro." He didn't have to do anything, but his promise saved the currency

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Recommended Reading

The Changing Face of World Oil Markets
James D. Hamilton
University of California, San Diego
July 20, 2014

Taylor Rule Legislation
Alex Nikolsko-Rzhevskyy, David Papell and Ruxandra Prodan
Econbrowser
July 18, 2014

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