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Europe needs time for pro-growth reforms to work -- instead, it has a too-tight central bank.

In an interview in France's *LeMonde* last weekend, European Central Bank President Mario Draghi repeated the now familiar mantras that "the euro is irreversible" and "they [investors betting on euro collapse] don't recognize the political capital that our leaders have invested in this union." These shopworn words, combined with an ineffectual interest rate cut, have left markets decidedly underwhelmed -- in fact, we think this disappointment at Draghi's impotence is what's behind the latest flare-up in Spanish and Italian debt.

But there is a major difference between a euro area that merely survives and one that has the potential to thrive. While the euro area is using the Rahm Emmanuel doctrine of never letting a crisis go to waste, the structural changes that have been undertaken (see "Europe's Supply-Side Revolution" February 17, 2012) take years to yield results -- and these are not easy years.

- The template for the structural changes in the euro area is Germany's Agenda 2010 doctrine introduced by Gerhard Schroder's government in 2003. It transformed Germany's economy into the strongest in the developed world, but Germany had the advantage of undertaking those changes during a period of sustained global growth.
- For Spain and Italy the reforms are happening against severe global economic headwinds.
- This does not mean they are destined to fail. In fact the failure to reform is the one sure path towards failure, as Greece is showing us. But strong economic headwinds mean that the investment environment that is improved by the reforms is being eroded by pervasive uncertainty.
- Survey data released today by the European Central Bank shows that demand for loans for fixed investment by companies has collapsed to an extent that is reminiscent of the worst of the Great Recession (please see top chart on the following page). Overall loan demand across all sectors continues to be negative, too, a factor likely to be reflected in tomorrow morning's M3 release from the ECB.

Update to strategic view

EUROPE MACRO, ECB, EUROPE BONDS: The ECB is too tight. He hints at easing, but Mario Draghi is unwilling to use his only high-powered tool with the ECB is trapped at the zero bound -- the Securities Market Programme as a means of QE. Loan demand in the euro area remains very weak, with fixed investment loan demand particularly badly hit -- a large headwind for economies that are trying to restore growth. They are running out of time, with investor patience exhausted by continued risk -- both real and perceived -- in sovereign debt. Unfortunately Draghi talks as though it's not the ECB's job to ease the pressure and allow the gift of time those economies so dearly need.

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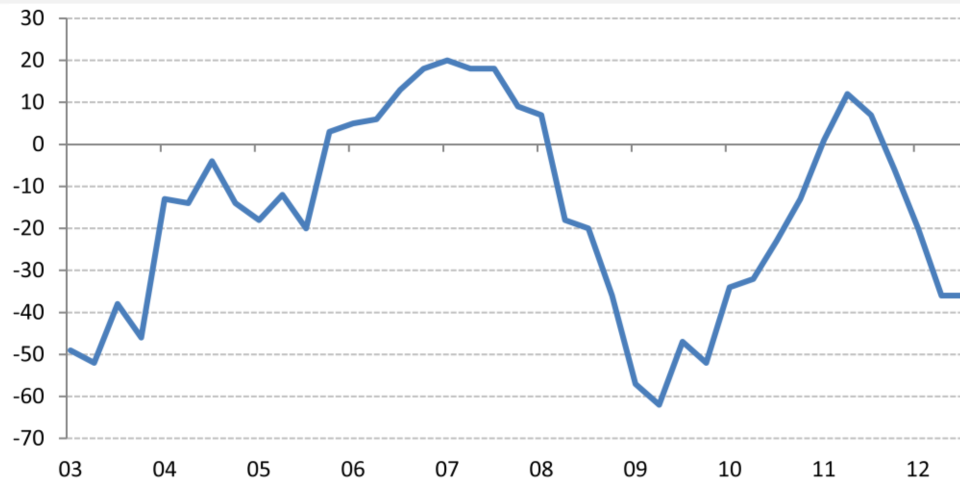
- While the German experience shows that things get worse before they get better after the Agenda 2010 reforms were introduced in last 2003 (please see the second chart below), the continuing collapse of fixed investment means that the potential for future growth on the timeline that is required by fixed investment -- months and years rather than days and weeks -- is already lower.

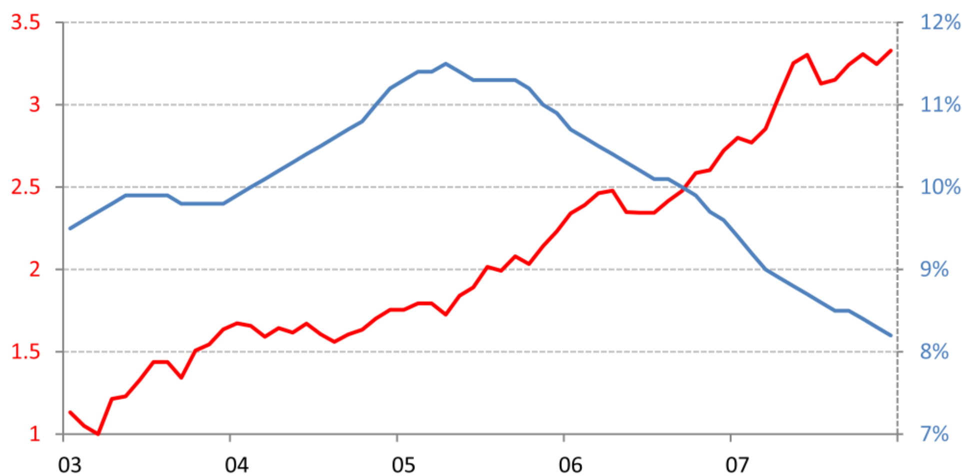
Credit demand by enterprises for fixed investment



Source: ECB

- Without a global growth tide to lift them, and with low investor confidence slowing down the private sector's response to reforms, the peripheral nations need more time than Germany did after 2003 for the reforms to take hold.

DAX stock index, normalized to 1 at 2003 bottom **Unemployment rate**



Source: Bloomberg, Eurostat, TrendMacro calculations

- Unfortunately, time is not something that is in plentiful supply for Spain in particular, but also for Italy. Further deterioration or even continuation of current sovereign bond yields is an unsustainable

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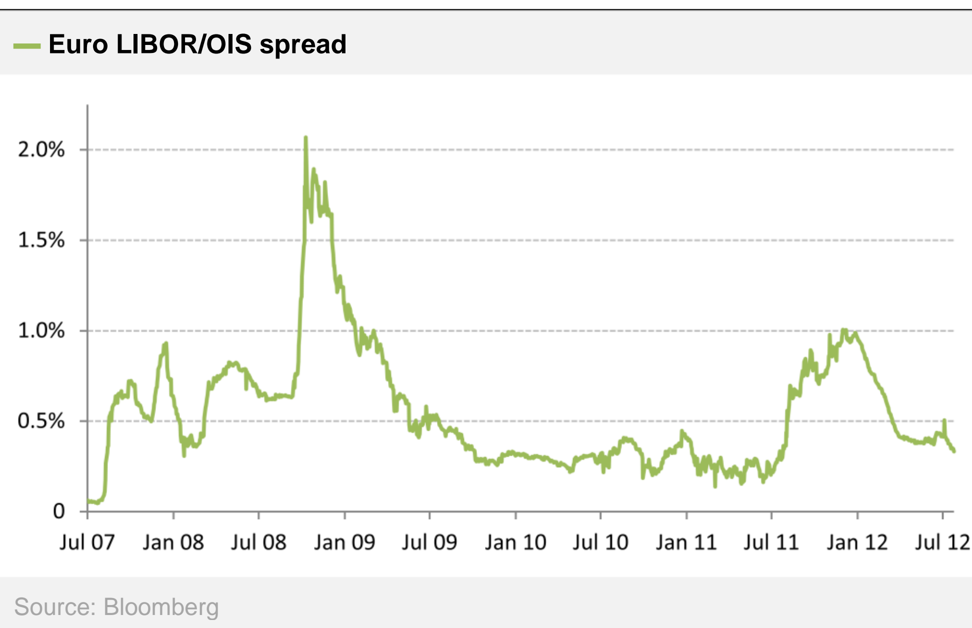
situation that could degenerate into a vicious cycle beyond the ability of policy makers to overcome.

While there is still time to act in a meaningful way, all eyes again turn to the only organization that has the resources to act: the European Central Bank.

Despite some notable successes -- the LTROs have been undeniably successful in easing bank funding worries (please see the chart below) -- the ECB under Mario Draghi has avoided doing much to ease the pressure on sovereigns. Draghi does correctly argue that there are limits to monetary policy's ability to solve the sovereign debt problem. But by all evidence the ECB is excessively tight, being the only major central bank in the world not to have implemented QE. An excessively tight central bank is one that is not yet at the limits Draghi talks about. In this sense, the celebrated Mr. Draghi is repeating the fatal error of his discredited predecessor Jean Claude Trichet (see "EUicide" April 7, 2011).



Source: Bloomberg

Draghi seems to be preparing the market more easing, citing deflationary expectations (see "On Eurogroup and Draghi in Parliament" July 10, 2012). But with no lending growth thanks to weakened credit demand -- this is not a credit availability issue -- and the subsequent breakdown of the monetary policy transmission mechanism, he will have to use channels other than interest rates to influence outcomes that fall under his monetary policy remit. Unfortunately, Draghi shows no sign of wanting to use what OECD Secretary General Angel Gurria yesterday called the ECB's "bazooka."

- Ideally he would allow the Securities Markets Programme to restart its bond buying operation. It is an effective instrument, and the July drop of the deposit rate to 0% means that he would not have a problem sterilizing SMP purchases. The most recent weekly

deposit-taking sterilization operation received €397 billion of bids for €211.5 billion of ECB demand. Those deposits attracted a weighted average allotted rate of 0.01%.

- The SMP would act as much-needed QE for the too-tight ECB.
- At the same time, it would be a much needed intervention in dysfunctional debt markets very much in the mainstream of classical doctrine on a central bank's mission to intervene in market failures. We don't usually agree with politicians who blame markets for their woes -- but we have some real sympathy now for Italian Prime Minister Mario Monti and Spanish Prime Minister Mariano Rajoy on that score.
- It would not only be buying bonds, it would be buying time for the countries undergoing difficult reforms to start reaping the benefit of those reforms.
- While the SMP cannot be a permanent solution, it should have a place in calming the markets at the moment. The long term is nothing more than a succession of moments. We have to get through them all, and the SMP is the best way of getting from this moment to the next one.

Unfortunately, Draghi seems to have decided that with the ECB stopped out at the zero bound, the only route to success in the euro area is through the supply side reforms he favors. While he is correct that they are the only route to renewed growth and sustainable fiscal profiles, they are not the sole crisis solution needed at the moment. He ignores the reality that the ECB is demonstrably too tight. He is like a doctor who prescribes no more skiing to his patient with a broken leg, but forgets to fix the leg. The patient will most likely not die, but will only be able to limp along, at best, in the future.

- With Draghi refusing to restart the SMP, the chances of the peripheral euro area economies doing any better than limp along are seriously reduced.
- Having done such a great job in providing a solution to the banking crisis, Draghi seems to feel himself absolved from acting to solve the sovereign crisis. Unfortunately, without solving the sovereign crisis too, he's sure to eventually have another banking crisis to solve.

In the meantime, we do have some other slightly more positive news from the ECB that may lead to some relief in the medium term. In an interview today, Austrian Central Bank chief Ewald Nowotny said that there were arguments in favor of allowing the forthcoming European Stability Mechanism (ESM) to have a banking license. This is not a new idea, having been discussed at a European parliament level as far back as December 2011, but it is one that the ECB has resisted until now. Movement on this would certainly calm markets, but it is unlikely to come about in the short term.

Bottom line

The ECB is too tight. He hints at easing, but Mario Draghi is unwilling to use his only high-powered tool with the ECB is trapped at the zero bound -- the Securities Market Programme as a means of QE. Loan demand in the euro area remains very weak, with fixed investment loan demand particularly badly hit -- a large headwind for economies that are trying to restore growth. They are running out of time, with investor patience exhausted by continued risk -- both real and perceived -- in sovereign debt. Unfortunately Draghi talks as though it's not the ECB's job to ease the pressure and allow the gift of time those economies so dearly need.