Re-Define Commentary by Sony Kapoor

Massive ECB intervention is necessary but insufficient

Large scale or open-ended ECB support for Spain and Italy is necessary but far from sufficient.

Given how important additional ECB support is to helping stem the panic in the Euro crisis at this stage, it is useful to look at how much it would actually help. An increasing number of shrill commentators have been implying that enhanced intervention from the ECB may be a 'silver bullet'. It will be no such thing. We at Re-Define have been calling for the ECB to do more since before this call became fashionable but we have no illusions about what such an intervention can achieve.

A thought experiment is useful here. Imagine if the ECB were to intervene in a massive way or promise to stand behind Italian and Spanish bonds no matter what. What then? Yes, the borrowing costs would come down, closer to the pre panic 3%-4% level. And this is the best and a highly unlikely scenario. As we wrote two weeks back, the ECB will likely come in with a divided governing council without consensus so will not be willing to fire all cylinders. Much more likely the ECB will use an implicit target of 5% or so in borrowing costs and will refuse to make any open ended commitment and hence will fail to define a bottom to the market over a sufficiently long horizon.

But putting all caveats aside, what if the ECB intervened in the manner that the Bank of England has been supporting the UK through quantitative easing. Where would that get us? It's instructive to look at the British situation here. The UK is enjoying record low yields with the UK government now being able to borrow for 10 years at close to just 2%, even as inflation rates remain stubbornly much higher so real interest rates are negative at many maturities. It also benefits from having a flexible exchange rate which has stood it in good stead in this crisis. But is the UK economy sound? Is it growing? The answer to both questions is NO. While it is true that the UK is not tethering on the brink of complete disaster, its situation is hardly enviable. Yet the best case scenario for Spain and Italy is to get into the UK's economic situation in the medium term. How bad is that?

Very bad, considering that in actual fact Italy and Spain will continue to face additional problems over and above what the UK does. Even under a best case 'massive ECB' intervention scenario, Spanish and Italian borrowing costs would not be brought down to UK level. Nor would they have access to economic adjustments through flexible exchange rates. Equally important, additional ECB intervention is likely to be conditional on much stricter austerity in the short term which will almost surely put a recessionary squeeze on the countries that are bailed out.

Just to put things in perspective, as a percentage of GDP, the ECB's intervention in sovereign bond markets is less than a tenth of what the Bank of England has done for the UK. All additional ECB intervention can do is to stem the immediate panic and buy 1-3 years for troubled sovereigns. The EU desperately needs growth and a growth strategy which ECB intervention can provide the economic and political space to implement. In addition it needs to credibly map out an end-game which addressed the biggest structural and institutional gaps in the construction of the Eurozone.