



## **Prisma Capital Partners LP May 2010**

### **Economic Commentary: European Central Bank Budgetary Package Gavyn Davies - Founding Partner and Economist**

The initial market reaction to the package of fiscal and monetary measures announced by the European Union last weekend has been optimistic. This seems justified as the package was considerably more significant than was expected, especially in the area of monetary policy. By accepting the need for the central bank to directly purchase public debt, the European Central Bank (ECB) seems to have potentially shifted its stance very meaningfully, despite having reiterated that stance in their council meeting only three days previously.

The package basically has two critical strands:

1. The EU has announced a budgetary package of contingent loans of around E500bn, which have been made available to the countries with weaker fiscal positions in the Eurozone. (The IMF facility adds about E250bn on top of this.) This is a big step towards creating a single fiscal authority in the EU, since it potentially involves a large underwriting of Mediterranean country debt by Germany and France. The fact that this facility is in place should greatly reduce the likelihood that Portugal, Spain and Italy will follow the example of Greece.

2. The ECB has for the first time said that it will buy government debt in secondary bond markets where this is necessary to restore orderly market conditions. This means that the ECB will buy Mediterranean country debt, and will probably sell the debt of Germany and other core member states. The ECB says that monetary conditions will not change, because it will sterilize the monetary effects of this operation, but there will still be a net injection of central bank support for the troubled bond markets.

Going into the weekend, the Eurozone appeared to be facing a situation in which they either had to increase the degree of integration in fiscal and monetary policy (i.e., to deepen the Union), or they had to consider a break-up of the euro. They have clearly chosen the course of greater integration.

We do not know how much of the contingent loan package will be drawn down, but if needed, it would be enough to cover the budget deficits of the troubled European countries for at least a couple of years. Nor do we know how extensive the ECB action may be. In theory, there is no limit to the use of the central bank balance sheet, except for the possible effects on inflation. However, the Bundesbank has already said that it opposes the new approach, and there may still be some questions over ratification of other parts of the package. This has already raised questions about whether the overall package will prove as significant in practice as it appears on paper.

The package clearly brings the EU much closer into line with what the US did in 2008/09 – e.g., to increase the central bank's balance sheet, and to use this to support the weaker parts of sovereign debt market. This should greatly reduce the chances that the euro will face a widening crisis in its weaker member states. I think this is a big change. (They have not yet, however, chosen to follow the Federal Reserve in increasing the money supply to purchase public debt. This would be an even bigger step, with possible long term inflationary consequences.)



Remember that the recent sell-off in the global bond markets has been restricted to the weaker members of the EU zone, which are unable to devalue their currencies, or to use their own central banks to monetize public debt. Importantly, the crisis showed no signs of spreading to other government bond markets, like those of the US, UK, Japan or Germany. Therefore, it was a crisis stemming from the design faults of the Euro-zone, not from doubts about the viability of sovereign debt more generally. The weekend measures are well directed to deal with the Euro-zone's design problems, at least for a while.

Finally, I think the events of the last few days demonstrate once again that the economic and financial recovery remains fairly fragile, especially whenever it appears possible that the central banks will start to withdraw their exceptional measures. (The main reason for the timing of Friday's dramatic sell-off was the hawkish tone in the ECB press conference last Thursday). However, we have also been reminded that, in the end, the central banks are willing to take whatever measures seem necessary to maintain the recovery, even if these actions have previously been said to be unthinkable. While the central banks remain in this state of mind, there is a decent chance that the markets will remain basically friendly to risk assets.