

## ECB Risks Nipping Green Shoots in the Bud



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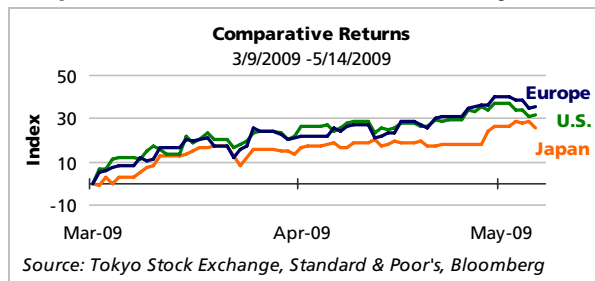
While there is much room for legitimate debate regarding how central banks should respond to the gravest economic crisis since the 1930s, and while the probability of policy errors is correspondingly high, there is little doubt that decisive leadership and clearly stated policy goals are vital to restore stability to financial markets and bleeding economies. At a minimum, one would expect that internal divisions by committee members are kept internal. The Fed has mastered this relatively effectively. The European Central Bank (ECB) seems chronically incapable of handling this very essential public relations principle.

This week the ECB did reduce its base rate to 1.0% as it reactively catches up with the Fed and the Bank of England. Of more concern is the very public dissension within the ECB regarding the bank's asset-buying program. Barely a week after the ECB president got warring parties to agree to an \$82 billion number, Germany is backpedaling while others suggest that more may be needed. Meanwhile the German and Italian economies contracted at the fastest pace on record in the first quarter of 2009: in this context, the \$82 billion is a small number. While fiscal and monetary discipline is a laudable long term objective, this floundering approach begs the question of what level of pain needs to be inflicted on the economy before the ECB (and by extension the EU as a political entity) feels compelled to step up to the plate in a concerted manner.

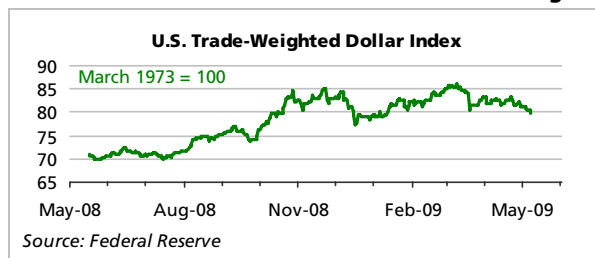
After a severe underperformance between mid-2008 and the major market low on March 9, the developed European markets have performed well against the U.S. and Japan (as reflected in Graph 1), with financials, industrials, and materials stocks leading the recovery. As grim as the economic outlook is, there were tentative signs that the rate of decline was diminishing, and that the sharp contraction in exports is in the process of stabilizing. The crucial question remains, however, whether the European banks and other financial intermediaries are now on an adequately sound footing to support credit activity and contain the economic fallout in a Eurozone economy expected to contract at a 4% pace in 2009. The stock market has in recent weeks factored in (at least implicitly) an economic trough by late 2009 or early 2010. The risk here is that a reluctant and divided ECB will frustrate this expectation and cause the outlook for both the economy and European stocks to deteriorate. The "green shoots," such as they are, need to be nurtured and reinforced by the ECB.

On the currency front, the euro has gained some ground against the U.S. dollar since early March. The

### European Markets Have Performed Relatively Well



### Dollar Weakness Should Relieve ECB Inflation Angst



trade-weighted dollar peaked at that same time and has depreciated by 7% since then (Graph 2). The ECB consequently has some room for additional stimulation as a weak currency and any lingering inflationary *angst* should not be on the radar. The expected 2009 Eurozone fiscal budget deficit is in the region of 6%, which (while admittedly double the maximum envisaged by the Maastricht treaty) compares favorably with those of the U.S. (-13%), the United Kingdom (-12%) and Japan (-6.3%). So there is, in a relative sense, some room to maneuver in support of internal demand. It is arguably simply too risky to be overly dependent on an improving export performance.

At the crux, Europe continues to grapple with what is a blend between a federation and a confederation. Individual national interests and perceptions are at the core of this indecision. From whom should the ECB purchase assets? Will it favor Italy at the expense of Germany or France? How much support should be given to Eastern Europe which is in the Union but not yet in the euro? These issues, historic in nature, need to be addressed urgently if the green shoots, particularly those in the stock market, are not to be exterminated by the cacophony of a discordant European symphony. Europe has confounded skeptics before, and may yet effectively address its internal divisions, but there is little latitude to continue in its recent vein at this critical time. ■

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