Investors Find Hope in ECB Announcements

September 14, 2012

The global economy has weakened with the prolonged euro-area crisis. Heightened investor fears have caused exaggerated government bond yields and interfered with monetary policy. However, by choosing a more direct approach to correct the bond market, the European Central Bank (ECB) has reined in fears of a euro-area breakup. Still, weak global demand could cause a decline in global trade. Export-oriented economies, such as Germany and China, have been particularly affected.

Fears of a Euro-Area Breakup Assuaged

The prolonged banking and fiscal crisis of the euro area has damaged investor confidence. Rising doubts of the euro area's long-term stability have distorted government bond yields. Government bond yields are a measure of the issuer's inherent risk. Yields rise with the potential of default as investments are reallocated to safer assets. High bond yields increase a government's cost of borrowing. Once a government's long-term bond yield exceeds 7 percent, debt becomes unsustainable. At the end of July, 10-year government bond yields for Italy hovered just under 7 percent, while yields for Spain surpassed the sustainability threshold. Conversely, German government bond yields reached record lows, as investors became more attracted to these safe assets. Germany's two-year government bond yield fell below zero in July. This diverging risk assessment is displayed in the bond spreads of Italy and Spain, which measure the difference between a country's bond yield and the German equivalent (Chart 1). These spreads have become exaggerated due to rising fears of a euro-area breakup. With bond yields no longer correctly measuring the inherent risk of the issuing government, monetary policy becomes less effective. Thus, the ECB's attempts to ease market conditions and restore confidence did not affect the bond market. Bond spreads continued to rise despite ECB lending to Spanish banks and a reduction in the policy rate.

Mario Draghi, president of the ECB, attempted to halt risk contagion. In a speech given on July 26, he assured that the "euro is irreversible," and pledged "the ECB is ready to do whatever it takes to preserve the euro." He succeeded in rallying investor confidence: Following his speech, bond spreads reversed trend, indicating the

Chart 1 10-Year Government Bond Spreads Rise with Investor Fear



NOTE: Spreads show yield differentials between the 10-year government bond of Italy and Spain and Germany's 10-year bond. SOURCE: Haver Analytics.

Chart 2 Two-Year Government Bond Spreads Fall



NOTE: Spreads show yield differentials between the two-year government bond of Italy and Spain and Germany's two-year bond. SOURCE: Haver Analytics.

strong influence of investor fear.

ECB Announces a New Plan

Following through with the commitment to do "whatever it takes," on Sept. 6, the ECB confirmed a much-anticipated government bond purchasing plan. This will replace the ECB bank lending operations. Stipulations of the bond purchase agreement require governments to enroll in a structural and budgetary reform program governed by the European Financial Stability Fund/European Stability Mechanism (EFSF/ESM). Once eligible, governments must also request bond purchases. The ECB will only buy bonds with

maturities ranging from one to three years because this aligns with the timeframe of traditional monetary policy. Stability in short-term bond yields should translate into stable long-term bond yields. The two-year bond spreads of Italy and Spain have already responded to the new ECB plan. Spreads have been on the decline since Draghi's July 26 speech when he hinted of the ECB's future intervention in the bond market (*Chart 2*). All ECB bond purchases will be "sterilized," meaning the ECB will remove money in circulation by an amount equal to the bond purchase.

This action should remove the market barriers that are preventing government bond yields from declining; however, once the barriers are removed, the individual governments are responsible for the actual decline, by complying with EFSF/ESM reforms.

Germany has openly voiced concerns over the bond purchases and the expanding authority of the EFSF/ESM. However, the German Federal Constitutional Court ruling on Sept. 12 that the ESM is not a breach to the German constitution suggests Germany will continue to contribute funding to the ESM. Germany's ESM participation is crucial to restoring investor confidence and euro-area stability.

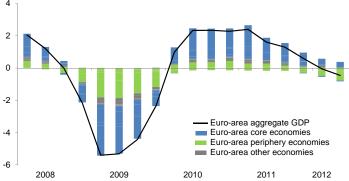
Euro-Area Problems Spread from Periphery to Core

As contraction in the euro-area periphery deepens, the once-resilient core countries are beginning to slow. Aggregate gross domestic product (GDP) growth for the euro-area economy has been bolstered by its two largest members, France and Germany, but now these economies are suffering from prolonged lack of demand (Chart 3). In France, second quarter 2012 GDP growth declined to 0.3 percent, year over year. In Germany, second quarter GDP growth fell to 1 percent, year over year. Monthly manufacturing purchasing managers index (PMI) indicators suggest Germany's third quarter GDP will contract (Chart 4). Germany's PMI increased slightly in August, up to 44.7 from 43.0 in July, but August represents the sixth consecutive month of falling manufacturing output. Declining output in the manufacturing sector is especially troubling given Germany's export-oriented economy.

Non-European Economies Also Slowing

With continued euro-area contraction prolonging a decline in consumer demand, world trade growth has slowed. As of June, the average monthly year-over-year growth was 2.2 percent—less than half of the 5.9 percent growth of 2011 (Chart 5). Growth rates in June and July were slightly above the year-to-date average, but the global manufacturing PMI indicates an upcoming contraction. The decline in aggregate demand and subsequent slow-down in trade volume growth have disproportionately affected the export-driven economies, including many of the emerging economies.

Chart 3
Core Contribution to Real GDP Growth Dwindles
Percent growth, year/year



NOTE: Core economies are Belgium, France, Germany and the Netherlands. Periphery economies are Greece, Ireland, Italy, Portugal and Spain. The other economies are Austria, Cyprus, Estonia, Finland, Luxembourg, Malta, Slovakia and Slovenia. SOURCE: Haver Analytics.

Chart 4
German Economy Headed for Contraction

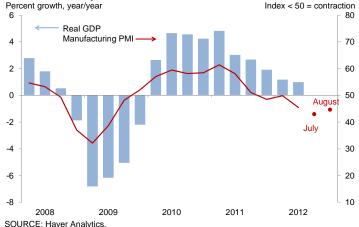
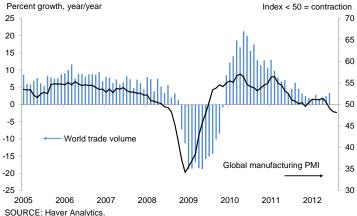


Chart 5
Global Manufacturing PMI Points to a Contraction in Global Trade



Though still a driver of global growth, China's economy has slowed. Real GDP growth was 7.5 percent in second quarter 2012, down from 8 percent in the first quarter. Second-quarter growth is consistent with the lower GDP growth target announced in March. This was motivated by the planned transition of growth orientation. China wishes to become less dependent on exports and rely more on domestic demand. However, multiple policy rate cuts and lowered reserve requirements suggest the current decline in growth might be more than anticipated.

Non-export-oriented economies are also slowing. On Aug. 30, Brazil's monetary policy rate was reduced to 7.5 percent, a historic low. The economy is suffering from falling consumer demand, the economy's largest contributor.

Outlook Remains Uncertain

The global outlook remains uncertain as the euro-area crisis continues to wear on investor sentiment. If the ECB can restore confidence, conditions should improve. Much depends on the actions of Spain and Italy, as bond purchases are dependent on structural reform implementation and a formal request. Germany's decision to support the EFSF/ESM will also help investor confidence. As euro-area confidence is restored, global demand will begin to pick up, causing a rebound in trade. This will allow a smoother transition for China to become a more domestically driven economy.

-Adrienne Mack

Note

 The EFSF was created at the onset of the European financial crisis to preserve the monetary union by aiding distressed countries. The ESM is the permanent replacement of the temporary EFSF organization

About the Author

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