



## Central Banks to the Rescue?

*Joseph E. Gagnon evaluates the impact of an increasingly interventionist European Central Bank and its coordinated efforts with the US Federal Reserve and other central banks.*

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Steve Weisman: The European Central Bank [ECB], the Federal Reserve and other central banks have sprung into action, offering glimpses of new policies in Europe. This is Steve Weisman with Joseph Gagnon at the Peterson Institute for International Economics. Joe, what is the most important thing we are seeing today (December 1)?

Joseph Gagnon: The president of the ECB, Mario Draghi, gave a speech today before the European Parliament, which I think is getting a lot of attention, and deservedly so, because he has been more explicit than he or his predecessor [Jean-Claude] Trichet were about what the ECB might do.

Steve Weisman: Some in Europe worry that the ECB is going to be too interventionist. That wouldn't be your concern, I guess, but explain what would be the outcome from the speech.

Joseph Gagnon: A little back story is that in the summer, the former president, Jean-Claude Trichet, and the current president, Mario Draghi, wrote two letters, one to the prime minister of Spain, and one to the prime minister of Italy, Silvio Berlusconi. The one to Berlusconi was leaked and published. It was an amazing list of requests that the ECB was asking the Italian government to do. Some of them on fiscal policy, making budget cuts, but even more interestingly and strongly, on reforms that would spur growth in the Italian economy by making labor markets and product markets more competitive and efficient, and giving investors a reason to invest in Italy. Then today, I think what you heard from Mario Draghi more clearly was that if Italy and Spain do what is requested and the Europeans set up a framework -- agree to move forward on changes to the fiscal framework that tries to put more discipline on countries -- the ECB will step up to the plate and be more interventionist. If the markets don't take that as enough to cease their attack and narrow their bond spreads that Italy must pay, the ECB will step in and do something about that. I think that he didn't spell that out, how much they would do or when and the details. But the fact that he even alluded to [it], that they would take other steps if these steps were taken first, is as explicit as you can imagine a central bank being about the quid pro quo for monetary policy.

Steve Weisman: In the United States, we've seen these trade-offs where the Fed implicitly cooperates on easing monetary policy if political leaders do their homework on fiscal policy. But we haven't seen that before in Europe.

Joseph Gagnon: Yes, we've had hints of it in America. This was even more explicit, where Draghi specifically said, "Other measures could follow if you do these things first." And I think it was pretty clear to say "other measures would follow." I think no one doubted that he meant, by the ECB. I think it means: look, if the ECB asked you to do something and you do it, I think

the ECB would say, “Your reward will come from the markets.” But the way the markets have been behaving lately is not totally rational. I think you cannot rule out the possibility that the markets might not reward Italy, even if they did what the ECB asks. And in that case, the ECB would have to step up to the plate. They would have to deliver. They would have to do a massive bond purchase to drive Italian rates back down, because the Italian economy simply is going to go into a massive recession if interest rates stay where they are.

Steve Weisman: As you say, markets are not totally irrational. That might be an understatement. But this is a remarkable historic turn of events, isn't it?

Joseph Gagnon: Yes. I'm sorry, you've got me thinking about market rationality. If I could just make a little point, which is, well, there's some rationality to what markets have been doing in the sense that they've been attacking the countries that were more vulnerable, mostly.

Steve Weisman: Right.

Joseph Gagnon: And you could see that there's a connection between the vulnerability and the fiscal bad behavior and the degree of the market attack. So that seemed rational. But lately they've gotten irrational in the sense that the Dutch, who actually arguably have the best fiscal position in Europe and the best economy in Europe, are paying higher interest rates than the Germans. Now that makes no sense. Markets have gone off the rails in some sense.

Steve Weisman: Why?

Joseph Gagnon: I don't know. [laughter]

Steve Weisman: OK, we can both laugh. The Dutch aren't laughing, I'm sure.

Joseph Gagnon: No, the Dutch are not laughing. I think the fact that this happened to them, despite them being the paragons of virtue, I think is probably pushing them in the camp of agreeing to help the Italians and Spanish.

Steve Weisman: That's interesting.

Joseph Gagnon: And the Germans themselves are starting to pay higher interest rates than the British.

Steve Weisman: Which makes even less sense...

Joseph Gagnon: I think to the Germans it certainly makes less sense.

Steve Weisman: Let's come back to the coordinated actions of the day before where the Fed joined in and took some actions to help financial institutions, especially in Europe, who are suffering from liquidity or interest rate problems. How do you assess this remarkable display of the coordination, not only of these two giant central banks, but with other central banks around the world, including China?

Joseph Gagnon: First of all, I don't think the China thing was coordinated. I think it was a coincidence. But the other actions were coordinated with the advanced economy central banks, and we have had that even after 2008. There were other steps on the swap lines. They were expanded

in 2009, I believe. So yes, it's probably been at least a year, if not two years, since this happened. I see that as a much less of a deal, much less of a surprise. It was totally expected that the Fed would lend to the ECB if the ECB wanted, so I don't think anyone doubted that. The fact that the ECB felt the situation was urgent enough to finally ask -- I don't know -- I'm surprised the markets took that as good news! It could just indicate that the pressures got really bad in European banking. Anyway, it confirmed at least -- if markets doubted it -- that central banks would cooperate. I didn't have any doubts, but perhaps the markets did.

Steve Weisman: Is Europe slowly creeping toward a much more muscular coordination between elected governments and central banks in trying to backstop banks and countries to avert a meltdown that some say could be as serious as the 2008-2009 downturn?

Joseph Gagnon: Yes, I think that this is good news. There is good news on that front, in the sense that the European politicians are getting closer and closer to doing the kinds of things that the ECB has wanted all along, and Germans have wanted, which is getting better behavior, first of all, by the people who have had bad fiscal situations, especially Spain and Italy. Those are the two countries that matter. And in Italy, we have a new government with a technocrat who has said he's going to do everything that the Germans and ECB want. In Spain, the party that seems most amenable to doing what the ECB wants just won a massive mandate at the polls. They will be taking office soon, in the next week or two.

So I think by the end of the year, some of the legislation, if not most of it, should have been passed in these two most important countries, and I think that's what the ECB is waiting for. So I think we're talking about weeks now, not months, to seeing the resolution of this. The one other piece. Any action that parliaments taken this year [by] the technocratic government could be unwound in the next two or three years, as new elections and new governments take place. I think that the ECB might be a little worried that while they'll bail them out, two or three years later there'll be problems again. I think that's going to be dealt with in the context of the negotiations that the Europeans are having about treaty changes that will take a couple of years to take effect, but that will enforce more fiscal discipline in the future. That takes time. But I think you're going to get some agreement to move forward on that soon, too.

Steve Weisman: Thank you, Joe.

Joseph Gagnon: You're welcome.

