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The Euro Is Facing a Make-or-Break Year in 2022: Richard Cookson
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(Bloomberg Opinion) -- For good or bad, the future of the euro will probably be decided this year. In an attempt to generate inflation, central banks have cut short-term interest rates to nothing or less over the past 20 years or so and expanded their balance sheets to levels that would have been previously unimaginable. TheEuropean Central Bank has been particularly aggressive. Euro deposit rates are minus 0.5% and the ECB's balance sheet is laden with 8.5 trillion euros ($9.66 trillion) of assets, four times more than at the beginning of 2015.
Where the ECB has differed from other central banks is in its other, generally unstated, aim: to keep the euro project on track by preventing yields on sovereign bonds issued by its weaker members from rising abruptly. As it turns out, this makes the euro much less stable. The ECB could pretend that insanely low short- and long- term rates had the aim of trying to drive up inflation when there wasn't any. The recent inflationary surge has put that pretense to rest. Inflation rose by 5% in December from a year earlier, Eurostat announced Jan. 7, its highest level in the history of the euro. Strangely, the ECB has continued to claim that this spurt is temporary. Given current extreme monetary policy settings, the ECB's intransigence can be understood only if you recognize that in recent years the central bank has not been independent in any meaningful sense. It is now firmly under the thumb of government borrowers, especially the weaker ones within the euro zone.
In recent months, euro zone creditor countries, generally in northern Europe, have become increasingly vocal that current policy cannot continue, both because they are worried about about domestic inflation and because they are fed up subsidizing more profligate countries. The deal stitched together late last year was that balance-sheet expansion would end and that the ECB would provide explicit criteria for shifting short rates higher. First, core inflation, which excludes food and energy, would have to be trending higher. Second, the ECB's inflation forecasts in the current and following year would have to be 2% or more. At the end of December, the central bank announced that it even though it expected inflation of 3.2% this year, the rate would miraculously drop to 1.8% in the following two years. More hawkish members of the ECB are openly questioning these predictions, including the influential Isabel Schnabel, the German representative on the governing council. On Jan. 8, she said the transition to a greener economy would very likely mean that energy prices areunlikely to fall, as the forecasts of the ECB's research department under uber-dove Philip Lane assume. If they only stay where they are, the ECB's inflation predictions would be substantially higher. This pressure opens the door for rate increases, perhaps even late this year. In the meantime, that screeching sound you hear will be the ECB slamming the brakes on balance-sheet expansion.
Broadly speaking, the ECB currently has three programs: a long-standing Asset Purchase Program (APP), the Pandemic Emergency Purchase Program (PEPP) and a third incarnation of a plan to encourage banks to lend to the real economy known as targeted longer-term refinancing operations, or TLTRO. The PEPP was launched in early 2020 to keep inflation expectations from falling, the ECB said at the time. Under this program, which is scheduled to end in March, the ECB has bought about 1.5 trillion euros of bonds. At its peak last year, the ECB's combined purchases of bonds under the APP and the PEPP were 100 billion euros a month. Although purchases from the APP will be increased a little to help offset the end of the PEPP, direct ECB purchases will fall to 20 billion euros a month by the end of the year. Given that inflation has been so persistently high relative to its target, and short rates are still so negative, the ECB may even end the APP as early as October.
Then there is TLTRO, which has allowed banks to fund themselves at up to half a percentage point less than the ECB's deposit rate, currently -0.5%. Such funding was meant to be used for lending to the real economy, but the conditions under which banks could borrow at very cheap rates were easy to finesse. Although some institutions have simply used this program to cheapen their overall funding mix, there is little doubt others have used the money to buy government bonds, even riskier ones. Although we don't know how much, the amount is probably large given that there are some 2.4 trillion euros of outstanding TLTRO loans. Those favorable terms run out on 1.2 trillion euros of the loans in June, and unless the terms are extended – and there is no rationale for doing so – we

may soon find out just how much was used to buy riskier bonds. All things equal, the ECB's balance sheet will probably contract by more than 1 trillion euros in June as its indirect support of bond markets diminishes.

What then? The biggest reason the ECB has been dragging its heels on ending these programs is that many on its council are frightened of what will happen to bond yields, especially those of the euro zone's weaker members on the periphery. The central bank has said it will intervene if yield spreads widen in unjustifiable ways. With what, though? And what counts as unjustifiable? The biggest concern is Italy, both for its size (it has one of the largest government-bond markets in the world) and its debt dynamics. Under the toothless growth and stability pact, countries in the euro are required to try and cap their debt to 60% of GDP. All members have seen their ratios head sharply higher over the last couple of years, but Italy's will have ballooned to about 155% of GDP this year, an increase of 50 percentage points since 2007. Italy's banks, moreover, are heavily reliant on the TLTRO program for their funding, so loath are banks elsewhere to lend to them. Such is the ineffectual state of successive Italian governments that politicians have done nothing to reform either the financial system or anything much else.

With the ECB rapidly running out of a market anesthetic, some sort of crisis this year is probably unavoidable. Most countries, especially debtor countries (including France), have driven a truck through rules designed to stop free riding on their creditor counterparts. Assuming that northern European countries say that enough is enough, an awful lot of credit risk has been building up, for which investors are horribly under compensated. As the ECB steps away from the market, I would assume that this will become all too apparent and yield spreads for riskier borrowers will widen, perhaps dramatically. There are broadly three ways in which this might be resolved. The first is for Italy to default. Since a lot of its debt is held domestically, this would essentially mean the government imposing losses on its own citizens. I'd count that as problematic. The second is for Italy to leave the euro. From an Italian perspective, this would have the advantage of imposing losses on creditor countries such as Germany via outstanding balances in the Target 2 "settlement" system. This option would make Brexit look like a playground fight. Which perhaps leaves some sort of mutualization of existing debts, shoving them from the ECB into a debt-management office and promising to do better in the future. Former ECB president and current Italian Prime Minister Mario Draghi and Emmanuel Macron, the embattled French president who is up for election in the spring, signed a joint letter just before Christmas implicitly calling for the transfer of all euro zone government debt since 2007 to such an agency. Germany would be furious with any such move. So would eastern European countries that spent years cutting debts to join the euro. For the euro to survive, compromise of some sort will be needed. The snag is that I can't see creditor countries agreeing until the potential pain is bad enough. And the potential pain would, I suspect, involve Italy threatening to leave the euro.