Merkel under European pressure

ECB in limbo after eurosceptic breakthrough

by David Marsh

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The European Central Bank (ECB) looks set to remain in a limbo for several months, perpetually poised to take aggressive monetary easing action but never actually able to do so. While policy-makers mull their options, the political climate is turning sour.

Germany's eurosceptic Alternative for Germany (AfD) performed much better than expected in elections in the eastern state of Saxony on Sunday, winning 9.7% of the votes and entering a state parliament for the first time.

Chancellor Angela Merkel's Christian Democrats won the vote with 39.4%, but this will be of scant consolation in view of the AfD's success. Merkel is not the only mainstream leader to face a fight from the eurosceptic fringes, seen by growing divisions in UK and French politics. But in view of Germany's pivotal position in euro area rescue schemes, the diverse strains on Merkel are more exacting than in any other European country.

Although the ECB is supposed to be independent of politics, it cannot be deaf to such mood music. Opposing concerns about the euro area economy are raising the political temperature throughout the 18-member bloc, subjecting the ECB to virulently conflicting pressures.

On the central question of whether the euro area is entering Japan-style deflation, those on different sides of the argument, with equal claim to plausibility, can point to latest data as supporting their case. ECB governing council members, meeting on Thursday in Frankfurt, will point to latest developments as both raising and lowering the need for full-scale quantitative easing (QE) in the form of full-scale purchases of government bonds throughout the euro area.

Traditional 'hard money' members of the council will point to slow improvement in depressed underlying credit and monetary conditions. They will say that the ECB's pipeline of liquidity measures is sufficient to generate a rise soon in the euro bloc's painfully low inflation rate.

Those calling for quicker steps will highlight a renewed fall in euro area inflation to 0.3% in August, down from 0.4% in July, and will call for the ECB to take the lead.

But for the time being a majority seems likely to espouse the line favoured by Mario Draghi, the ECB president, in blaming the inflation fall on special factors and delaying major moves until conditions are clearer. The fall in the euro exchange rate – the one clear short-term policy goal enunciated by Draghi in recent weeks – will over time help move up the underlying inflation rate to closer to the 2% medium-term target.

Draghi is believed to view full-scale QE only as a last resort because he, like many people in Germany itself, believes it would lower pressures on governments to take much-needed political action to revitalise economies. He knows QE would spark great opposition in Germany. Furthermore, it would enshrine the reality of deflation. Since Draghi has argued with apparent conviction that the euro area slowdown in inflation is not a harbinger of Japan-style gloom, changing his line would be an embarrassing blow to Draghi's credibility.

Some form of action through a further symbolic cut in the ECB's already-negative interest rates may ensue this week. However, structural steps through the launch of a scheme for the ECB to purchase asset-backed securities to regenerate the securitisation market in Europe are still some way off. A decision on full-scale QE is also not likely before the end of the year at the earliest.