European Central Bank president's interview sends euro to four-year low

Nick Beams
3 January 2015

European Central Bank President Mario Draghi has given his firmest indication yet that the ECB will step up its program of quantitative easing, supplying even more ultra-cheap cash to financial markets, when the governing council holds its next meeting on January 22.

His remarks, which were contained in an interview published in the German business newspaper *Handelsblatt*, came amid further signs that the eurozone is moving into a situation of outright deflation.

Following the publication of the interview, which was seen as a move by the ECB president to overcome opposition in Germany to further quantitative easing (QE) measures, the euro fell to its lowest level against the US dollar in four years. Yields on European government debt also went to new lows—an indication of deflationary pressures—with interest rates on five-year German debt turning negative for the first time, meaning that in effect investors are paying to lend money to the government.

Draghi told the newspaper that the ECB had a mandate to keep inflation close to but below 2 percent. "That is our legal obligation. And we must deliver, within our mandate given by the European Treaty." That mandate is far from being met.

Official figures due to be released next week are tipped to show that the eurozone inflation rate has fallen below zero because of the sharp decline in oil prices, possibly signalling the start of a deflationary spiral.

The credit chief at the Royal Bank of Scotland, Andrew Roberts, told the London-based *Daily Telegraph*: "The eurozone is sinking into corrosive deflation and it is too late to stop. We think the inflation rate in December may already have been negative. The ECB are in trouble and they know it."

The danger of deflation, Draghi noted in the interview, was that if prices were expected to fall even further then spending decisions would be delayed. "We are not there yet. But we need to tackle this risk."

Draghi said the risks of the ECB not fulfilling its mandate on inflation were "higher than they were six months ago." Asked about his aim of expanding the ECB's balance sheet by €1 trillion, he said: "We are making technical preparations to alter the size, pace and composition of our measures in early 2015, should it become necessary to address risks of a too-prolonged period of low inflation. The governing council agrees unanimously on that."

The latter comment was directed against perceptions that the ECB will not be able to move because of opposition from within leading German financial and political circles to the further escalation of the QE program.

Asked about the opposition of the president of the German Bundesbank, Jens Weidman, who considers the large scale purchases of government bonds that would form the centre of any expanded QE program unnecessary and illegal, Draghi stuck to his previous comments that there had been "several interesting conversations" on the subject.

Treading a fine line, he insisted that the "purchase of government bonds is one of the tools in our toolbox, which we can use to fulfil our mandate" while at the same time making clear that the ECB was not able to implement "monetary financing."

It appears that the "technical preparations" to which Draghi referred are aimed at devising a financial mechanism whereby the ECB can purchase sovereign debt without directly financing any particular government.

Draghi has been at pains to try to minimise the differences on the ECB governing council, especially with Germany, the largest economy in the eurozone, by referring to "interesting conversations." But these differences emerged in the course of one extraordinary exchange in the interview.

Asked whether, notwithstanding German opposition, Europe did not ultimately need eurobonds, that is, common bonds guaranteed by all states, Draghi replied: "That requires trust in your partner. Asking this now is the wrong question at the wrong time. Such a climate of trust needs to arise."

Responding to a comment by the interviewer that he was under "immense pressure," Draghi said awareness of his obligations gave him strength, bringing the response from the interviewer that his remarks sounded "very Prussian for an Italian." Draghi then replied: "I believe that fulfilling one's obligations is not a national peculiarity of the Germans."

While the exchange may have had a certain light-hearted character, it did point to the tensions at the centre of the ECB.

Draghi is under pressure from financial markets, in particular British and US banks and financial institutions, to unleash even more supplies of cheap money. German banks, however, are fearful that an expanded QE program will make them ultimately responsible for the debts of other European governments and thereby weaken them against their global rivals.

The underlying recessionary trends in the European economy fuelling deflation were underscored by the latest results from the purchasing managers' index compiled by the firm Markit. The index for the manufacturing sector was 50.6 for December, just above the level of 50 which separates growth from contraction. France and Italy experienced a downturn, with Germany recording a modest increase.

Commenting on the result, Markit chief economist Chris Williamson said: "Eurozone factory activity more or less stagnated again in December, rounding off a year which saw an initial, promising-looking upturn fade away and stall in the second half of the year."

The measures undertaken by the ECB have done nothing to boost the underlying economy but have had their most significant impact on financial markets.

As the *Handelsblatt* interviewer noted, much of the money had flowed into markets for shares, real estate and art, with the price of the shares in the financial firm Allianz doubling in the space of three years without "there having been any change in the management, the strategy or the products."

Draghi acknowledged there was a risk of another crisis but claimed that there were no "speculative bubbles at this time."

Throughout his interview, Draghi emphasised the policy on which all sections of the financial and corporate elites in Europe and internationally are agreed, the need for further pro-business measures and attacks on the working class.

Asked why Europe was lagging behind the United States, Draghi pointed to the lack of "effective structural reforms"—the code phrase for such measures—and contrasted the higher income tax rates in Europe in comparison with those in the rest of the world.