# ECB at 20 can’t shake existential angst amid enduring Italian crisis

The European Central Bank’s 20th anniversary arrives today as another financial scare – this time in Mario Draghi’s Italian homeland – shows that the euro area still hasn’t grown up.

It’s a chance for the ECB president to remind governments that their political project, to create a monetary union out of economically and culturally disparate sovereign nations, is far from finished. As anti-establishment populists gain ground across the bloc, the risk is that the single currency’s weaknesses could allow it to be ripped apart.

Italy highlighted that tension this week when a euro-sceptic finance minister nominated by democratically elected politicians was vetoed by the nation’s president, putting the country on course for new polls. Bond yields soared in the country, but also in neighbouring Spain and Greece, awakening memories of 2012 when investors bet the eurozone would splinter.

“The euro keeps catching up with the effects of the last crisis and then another one breaks,” said David Marsh, head of OMFIF, a think-tank for central banking, and author of books on the history of the euro. “Either you move to some kind of political union with genuine pooling of sovereignty – a genuine sharing of risks including necessary debt restructuring, which is pretty large step – or a danger of some catastrophic crisis or a breakup becomes more acute.”

Some of those concerns will be addressed by European Union leaders at a summit on June 28-29, where German Chancellor Angela Merkel and French President Emmanuel Macron have pledged to present a joint initiative to boost the union’s resilience.

Major progress might be hard to agree on though, as Merkel faces resistance from among her allies and parts of the opposition. She’s unlikely to loosen her stance given that Italy’s election earned victories for parties promising big spending in the country that already has the euro area’s largest debt burden.

“The main issue is that participation in the euro requires countries to respect certain conditions and rules,” said Francesco Papadia, who was head of the ECB’s market operations from 1998 to 2012 and is now a senior fellow at the Bruegel think-tank in Brussels. “If these conditions and rules are not respected, the construction is shaken.”

The ECB itself is certainly is stronger than on June 1, 1998, when it was formed out of the European Monetary Institute and set up in a rented tower block in downtown Frankfurt. That was seven months before the euro was introduced.

“European Monetary Union was an hubristic endeavour from the start, full of unprecedented ambition in historical terms. The initial minimalist design didn’t do justice to the wide-ranging implications of the project. The framework is not yet complete and is still risking existential threats” ECB vice president Vitor Constancio said on May 17.

The central bank has taken on responsibility for banking supervision, and developed powerful new tools such as quantitative easing, negative interest rates and free bank loans to guide the eurozone through two financial crises and avert the risk of deflation. Eurozone membership has jumped to 19 countries from 11.

Yet it also became a lightning rod for public discontent. Its new €1.3bn ($1.5bn) headquarters was a focal point for riots in 2015, and the institution was in the crossfire the same year as Greece was forced to impose capital controls. Core countries Germany, France, the Netherlands and Austria have all seen the rise of political groups opposed to the euro and to deeper integration.

Sweden's Riksbank, the world's oldest central bank, is celebrating its 350th anniversary this year. Speakers at a conference last week to mark the occasion included the heads of the 324-year-old Bank of England, Mark Carney, and the 105-year-old Federal Reserve, Jerome Powell.

The ECB is a newborn in comparison, but one tasked with being the custodian for the world's second-biggest currency.

"Can a currency survive without a political union, a monetary union without a political union?" Otmar Issing, the institution's first chief economist, said at the event. "How must the monetary union be reformed to make it less fragile in the context of crises? These are the challenges which the ECB will be confronted with for, I am afraid, some time to come."

Outgoing ECB vice president Constancio echoed that sentiment in more granular form in a video posted on Twitter yesterday, the day of his retirement.

"The crisis itself showed that the initial design of the monetary union was insufficient," he said, highlighting flaws from a lack of common deposit insurance to the need for a region-wide capital market. "Monetary union, being a collective endeavour, needs at the centre a macro stabilisation function – and that has to be done by introducing a stronger coordination of fiscal policies."

# Headache for ECB as populists take power in debt-laden Italy



FRANKFURT AM MAIN (AFP) –

The arrival of an anti-austerity, populist government in Italy has revived concerns about the country’s massive debt pile, underscoring the pitfalls ahead for the European Central Bank as it tries to wean the eurozone off its massive monetary support.

“It’s the elephant in the room, because the problem was never resolved,” said Pictet Wealth Management economist Frederik Ducrozet, noting that Italy was the only “highly indebted” euro nation not to embark on a structural reforms programme.

After a political rollercoaster ride that sent markets into a spin this week, a coalition government between the far-right League party and the anti-establishment Five Star Movement is to be sworn in Friday.

While immediate fears that the eurosceptic parties could yank Italy out of the single currency have been calmed with their pick of a pro-euro economy minister, the drama in the eurozone’s third largest economy is far from over.

Both parties came to power promising tax cuts and higher spending — in a country already saddled with 2.3 trillion euros ($2.7 trillion) of debt and plagued by low growth.

At 132 percent of gross domestic product (GDP), Italy’s debt burden is second only to bailed-out Greece, and more than double the European Union’s 60-percent ceiling.

The near-collapse of the two populist parties’ efforts to form a government and the prospect of snap elections sent Italian bond yields spiking in recent days, making it more expensive for the government to borrow money.

The bond market turbulence spread to Spain and Portugal, prompting the Frankfurter Allgemeine Zeitung to warn of “contagion danger” that could send Italy’s debt woes spiralling out of control, dwarfing the Greek debt crises and posing a threat to the single currency in the long run.

That doomsday scenario appears to have been averted for now, and Italian yields fell on Friday as investors heaved a sigh of relief over the deal clinched in Rome — a welcome birthday present for the ECB on the day the Frankfurt institution celebrates its 20th anniversary.

– Balancing act –

The markets’ anxiety about Italy comes at a sensitive time for the ECB, the eurozone’s chief firefighter in a financial crisis.

After years of ultra-loose monetary policy aimed at bolstering growth and pushing up inflation to the bank’s target of just under 2.0 percent, the ECB is inching towards turning off the easy money taps as the eurozone recovery has gathered strength.

Although it is still buying 30 billion euros in bonds each month, including Italian debt, it is widely expected to phase out the so-called “quantitative easing” programme this year, before raising its record-low interest rates in the second half of next year.

But the bank’s slow-motion stimulus exit has been complicated by the euro area’s shaky first-quarter growth figures, leaving observers to debate whether the region has hit a mere soft patch or if a downswing is in sight.

For now, most expect the ECB to stay on the sidelines of the Italian turmoil and continue carefully preparing markets for its stimulus wind-down at the next governing council meeting on June 14.

Already holding some 22 to 25 percent of Italian public debt, the independent ECB “doesn’t want to and can’t be perceived as aiding any specific country,” said Ducrozet.

– ‘No easy option’ –

In the short-term, the Italian woes could paradoxically even boost the ECB’s efforts by weakening the euro against the dollar. A weaker euro makes imports more expensive, driving up eurozone inflation.

Provisional inflation data released this week also seemed to support the ECB’s plan to begin phasing out QE, with inflation hitting 1.9 percent in the eurozone, 2.0 percent in France 2.2 percent in Germany — well past the ECB’s target.

But as calls mount for the central bank to withdraw its crisis-era medicine, particularly in Germany, a return to higher interest rates will make it harder for heavily indebted nations like Italy and Spain to service their debt.

And if the populists in Rome stick to their spendthrift campaign pledges — including a universal basic income for Italy’s poorest and rolling back pensions reforms — Italy’s deficit could climb to between “five and seven percent” of GDP, according to analysts at M.M. Warburg bank, putting the country on “a collision course” with European partners.

The Warburg economists predicted that Italy may eventually need some kind of European aid or debt relief to prevent a full-blown crisis.

“There’s no easy option if Italy needed help tomorrow,” said Pictet’s Ducrozet. “And that’s why the ECB will be very cautious about when to raise interest rates.”

by Coralie FEBVRE