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Markets honoring reform progress

by Michael Heise

Bulls are ruling the roost on the financial markets. Investors are evidently confident that the euro debt crisis can gradually be overcome. Neither the crisis in Cyprus nor the problems in Italy or Portugal unsettled the markets, not a trace of the fear and horror seen last summer. Trust among banks is gradually returning. Long-term ECB loans are being paid back ahead of maturity because the money market is now functioning more smoothly again and costly liquidity cushions at the ECB can therefore be reduced. Cross-border lending is also showing signs of life again; whereas capital flight was the order of the day a year ago, money is now flowing back (if not in torrents). As a result TARGET2 balances are also shrinking: German net claims dropped below EUR 600bn in March, having peaked at EUR 751bn in August 2012 – a first welcome decline in these latent risks in the central banking system.

How sustainable is this return of confidence on the markets? Is it based solely on the ECB pledge to do whatever it takes to preserve the euro? Mario Draghi's proclamations doubtless play a key role but are not the sole factor. The financial markets are now also acknowledging the reform drives in the individual euro countries. Falling unit labor costs are boosting competitiveness; rising exports are helping to tidy up current account balances and, despite the grim economic environment, the consolidation of public sector finances is making headway – in many countries more slowly than planned, but nonetheless. Private sector debt is also being reined in gradually. Setbacks in one country no longer prompt the blanket condemnation of all struggling countries. In conjunction with the rejection of the reform package in Portugal, Portuguese spreads ticked up slightly while Spanish and Italian spreads fell at the same time.

However, the return of market confidence in the ability of policymakers to act can also evaporate again if the agreed measures are not implemented resolutely. Not least, this also applies to the plan for a banking union. In the wake of Cyprus, joint supervision along with uniform and binding rules on the closure and restructuring of banks – including the means to see such steps through – is more important than ever.

The apparent patience of the financial markets should not therefore lead to false conclusions. Policymakers have to perpetually earn the "calm" on the markets afresh. Backpedaling on launched reforms or a protracted standstill in individual countries would send risk spreads soaring again. But it is precisely this mechanism that will keep policymakers on course, regardless of party-political constellations. Because a genuine disposition to leave the eurozone is not evident anywhere, whatever protest parties may claim.