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Robert Levy
MA (Economics)
Director
rlevy@bordergold.com
(604) 535-3287
www.bordergold.com

A Long Bridge to Where?

"The best the ECB can do is to buy time in the hope that other policy-making entities with better instruments will step in, both at the national and regional levels"
-Mohammed El-Erian, Former CEO of PIMCO

There was certainly no shortage of action in the markets this week. Following a week when the Swiss France made a 30 per cent move in a matter of seconds, it would have been hard to believe we could match the week prior in terms of volatility and excitement. We are currently witnessing an undeniable shift in monetary policy. Six years since a financial crisis, and just recently the consensus was for an improving economy and a rising rate environment, but instead we are now seeing round two of central bank stimulus with a number of G20 central banks participating.

The surprise for the markets this week was provided by the European Central Bank. Somehow the ECB was able to deliver investors an open ended stimulus program that exceeded expectations. The oft-quoted Mario Draghi line from the summer of 2012 pledging to do whatever it takes to preserve the Euro finally came to fruition. The ECB President, Mr. Draghi and his team of central bankers delivered a US Fed style open ended stimulus aimed to buoy risk assets and support the sovereign debt markets of member nations. The question is, will it work?

The shortfall with Quantitative Easing in the United States was very simply the fact that there were no complimentary fiscal policies. Too many analysts and commentators concentrate on the actions of central bankers and whether or not there policies are justified. This is the wrong question to be asking.

A prime example of this was the Swiss National Bank's decision last week to abandon the peg. Their balance sheet had grown so exponentially, and would have been under even more pressure to support the Franc given the action seen in the Euro this week. Abandonment was more an inevitability than a decision. And in the United States, 2008 and 2009 saw credit markets freeze and a slow response in terms of fiscal policies. The Fed bought time for the economy by keeping rates near zero, keeping downward pressure on long term debt markets, and an imperfect response, but created a wealth effect in the equity markets to hope for increased consumption and spending in the economy.

Similarly, the Europe Union will see similar outcomes, but faces similar challenges. Moreover, the situation there is posed as even more challenging given already politically unpopular and unfavourable policies and social unrest. One common example of this, and has been evident through the Euro Crisis is small businesses through Europe cannot get affordable credit and loans because the financial institutions don't want the risk. The transmission of the process undertaken by the ECB to the financial institutions to the lenders is broken, and that's just one task to fix.

Mohammed El-Erian's quote above addresses the shortfall in the ECB's policies. Many have referred to these coordinated actions by central banks as building a bridge to nowhere. I don't like to be that pessimistic. But the point is that monetary policy will not be a sufficient solution to spurring economic activity should they not be accompanied by policies from fiscal and regional levels of government. Time will tell if my views will have to shift.