**No way out for the ECB spells trade war and collapse of European status quo**

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Markets have not been slow to see through the hollowness of the ECB’s announced curtailment (December 8) in the pace of money printing from April next year – 80 billion euros per month down to 60 bn per month, but a 9-month rather than usual 6-month fixed period until further review.

60bn is a huge number and the persistence of the ECB in sticking to its radical policy suggests that Chief Draghi and ultimately Chancellor Merkel are deeply anxious about the dangers of financial crisis ahead which could rock the status quo in Europe. The potential triggers to crisis include first and foremost Italy – but also the looming elections in Holland and most importantly France.

Everyone and their dog in the market-place realize that an EMU debt crisis before the German elections next Autumn could sink Chancellor Merkel.

There is a deeper problem here.

It is becoming clear that even beyond Europe’s election season, “monetary normalization” may well not be feasible here.

To understand this we should realize that monetary normalization in any real sense (not the Bernanke-Yellen-Fischer sense of embarking on minute highly broadcast rate rises whilst leaving everything else unchanged including a wide-open box of non-conventional tools) has three main component – first, the restoring of monetary base to the pivot of the monetary system, meaning a big shrinkage in the central bank balance sheet; second a freeing of interest rates from central bank manipulation, and third the repeal of the 2% permanent inflation target in favor of stable prices in the long run (but not short run).

Markets realize that the US may go down this road under the incoming Trump Administration, at least until the next crash and recession. The exact timing of entry could depend on when Chief Yellen retires or resigns. But the starting point is a detail, and in any case the new Administration can give a strong signal of intent by its choice of two Fed governors early in the New Year and its nomination of the new Chief to be, (an announcement widely expected by mid-year).

Information could emerge by then (mid-year) about how monetary normalization in the US is to proceed. Most likely this will involve the White House brokering a deal between the Fed and Treasury whereby the former swaps its portfolio of long-maturity treasuries (and possibly mortgage backed securities) with the latter in exchange for short-maturity T-bills, which can then be sold off rapidly in the markets in an open market operation which would shrink the monetary base.

True, Ms. Yellen and Mr. Fischer would not contemplate such a deal, as it appears to run contrary to much-vaunted central bank independence. But a deal is patently practical between two Trump nominees – at the Fed and Treasury respectively - and it would be widely approved of by many who are enthusiastic about sound money.

Problem: any intimation of such a deal and path ahead would send the dollar up against those currencies where no such normalization is practical – demonstrably Europe. And of course China is a whole different topic, but any monetary normalization is light years away given the huge financial risks there.

So Germany with the largest trade surplus on Earth (its current account surplus next year could reach 9% of GDP) becomes a candidate country for naming and shaming in the semi-annual report put out by the Treasury on currency manipulation. And in the past Germany has been mentioned as a possible candidate for that list though not actually put on it. China in its defense of huge trade imbalances is quite ready if the past is any indication to point to Japan and Germany as offenders which should also be brought into the discussion.

But this time round Japan is in a different situation.

It is well within the realm of the politically possible that PM Abe and his central bank chief Kuroda would copy the US example in organizing a swap to bring down the monetary base (the two parties would be the BoJ and the Ministry of Finance). And before then there is widespread expectation that the BoJ will move away from its present pegging of long-term rates at zero (via potentially huge but volatile intervention financed by money printing), most likely in two stages (first moving the peg upwards, then abandoning it).

The over-riding priority for Tokyo could be solidifying the strategic alliance with Washington not least in view of the rising geo-political dangers related to China and the vacuum now remaining after the collapse of the Trans-Pacific Trade deal.

Is it possible that the ECB and Berlin could have second thoughts about monetary normalization in the context of a threatened trade war with the US?

Yes they are sure to have second thoughts but what can they do?

There is no European Finance Ministry with which all the bad loans and bonds in the ECB balance sheet can be swapped for T-bills. And if the German, French, or Duch finance ministries were to step up to the task, their governments would have to recognize the huge losses to date in ECB interventions to “do whatever tit takes to save EMU”.

And so it is not just popular elections that now challenge the status quo in Europe. Trade war lurks not far behind. And this is a challenge not just for the modern Chancellor Metternich and the European status quo but also for global prosperity.