A critical few weeks for the eurozone

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The markets are waking up to the fact that the euro area faces a critical few weeks in which its economic path for 2015, and maybe for much longer, will be largely determined. Three inextricably linked events will dominate the economic landscape in January: the preliminary opinion of the Advocate General of the European Court of Justice (ECJ) on the legality of central bank bond purchases, due on January 14; the decision of the European Central Bank's governing council on the size and type of "sovereign" quantitative easing (QE), due on January 22; and the Greek election on January 25.

At the optimistic end of the spectrum, the euro area might emerge with a more complete monetary framework that for the first time enables it to pursue monetary policy effectively at the zero lower bound for interest rates, and with the sanctity of the currency area reinforced. At the pessimistic end, the ECB could become shackled with an ineffective version of QE just when the euro area is officially entering outright deflation, and the single currency itself might become incompatible with political realities in Greece.

The outcome will also have much wider global implications. The markets have remained relatively relaxed about the likely exit of the Federal Reserve from its own zero interest rate policy in 2015, but only because the ECB and Bank of Japan are injecting more monetary stimulus. If large scale ECB action is removed from this equation, sentiment on global risk assets may darken considerably.

The first potential stumbling block is the ECJ opinion on the legality of the ECB's Outright Monetary Transactions (OMT) programme. The German Federal Constitutional Court (GFCC) expressed major concerns about the legality of the OMT last February, saying that it might breach EU primary law if pursued in the manner originally outlined by the ECB. The GFCC therefore asked the ECJ for a ruling on the OMT, and there will be a preliminary indication from the Advocate General on January 14.

These OMT concerns would almost certainly also apply to a wider programme of government bond purchases by the central bank under quantitative easing, so they will need to be built into the ECB's decision on QE on January 22. It would be a foolhardy ECB president who failed to make his form of QE compatible with the ECJ's opinion on OMT bond purchases. Mr Draghi is not foolhardy.

From this economist's non-legal point of view, the GFCC has objected to the OMT because:

- it might breach (or circumvent) the principle that budget deficits must not be monetised;
- it might involve a mutualisation of government debt, which is considered an "economic" policy, beyond the monetary policy mandate of the ECB, and
- it might breach the principle of "non bail out" of governments by the "Union", in this case via the activities of the central bank.

It is not yet known whether the ECJ will agree with these concerns.

Both the ECJ and (previously) the GFCC are generally thought to lean in favour of decisions that promote further integration within the EU, so the legal outcome might be fully supportive of the OMT. Perhaps more likely is a ruling that permits bond purchases by the ECB as long as they are subject to further restrictions. In particular, the GFCC is concerned that the purchases should not be open ended, that they should be restricted to pure monetary policy purposes only, and they should not involve the mutualisation of debt.

All of these criteria have been repeated by Bundesbank President Jens Weidmann, and it has been widely reported that the ECB is considering a specific form of QE that would be compatible with them.

A leading option is to conduct bond purchases across the entire monetary union according to the ECB's capital ownership, but crucially to leave the risk for any subsequent default on these bonds in the hands of the national central banks. This would be compatible with Mr Draghi's openly stated desire for a "pure" monetary policy instrument, because it would increase the euro monetary base, without involving any form of mutualisation of government debt. It would have many of the same monetary attributes as Fed-style QE, which worked through exchange rate and portfolio balance effects as bond duration was removed from the market.

So would this finally clear the way for large scale sovereign QE? Certainly, the Bundesbank might be willing to support this form of QE on a larger scale than any other form. But there would be drawbacks.

The absence of debt mutualisation could backfire by increasing spreads on peripheral market debt, and thus increasing the fragmentation of monetary policy. In a future euro crisis, the question of how a national central bank could reimburse the ECB for possible losses on its government's bonds acquired under the QE programme could become a major drain on confidence, as markets focused on the solvency of individual central banks.

But in more normal circumstances, such as those that apply today, this solution would probably have most of the beneficial consequences of a Fed-style monetary easing at the zero lower bound, especially if the Bundesbank can be brought onside. It is not a bad option.

Finally, there is the thorny matter of the Greek election (well covered here by Lorenzo Bini Smaghi). So far, the markets seem surprisingly untroubled by this, except insofar as it could delay QE more generally. Investors apparently believe that the inevitable negotiations between the new Greek government and the troika on extended debt maturities will eventually succeed, without causing much contagion elsewhere.

It would obviously be very difficult for the ECB Governing Council to announce a programme of purchases of Greek debt only a few days before the possible election of a Syriza government, pledged to renounce that debt. But that problem could be mitigated by retaining the Greek bond purchases on the balance sheet of the Bank of Greece, not the ECB as a whole.

In any event, it would surely be absurd to allow the extreme problems faced by Greece to derail the monetary policy now urgently needed by the Union as a whole.