FOREX FOCUS: Do Not Exit Here

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LONDON (Dow Jones)--Ireland has just slammed the door on Jean-Claude Trichet's exit strategy.

Or, to be more accurate, poor market reaction to Ireland's EUR85 billion debt bailout has slammed the euro.

The European Central Bank's president has long been edging towards the exit, nervous that the bank's provision of ultra-cheap liquidity for the euro-zone banking community is stoking inflation problems for the future.

With the bank's staff likely to upgrade both its growth and CPI forecasts at this week's ECB meeting on Thursday, there has been even more pressure on Trichet to call an end to this support for the euro zone's banks.

Now he can't.

Not only do financial market conditions suggest that euro-zone banks will continue to need cheap money, but any suggestion that the central bank is moving towards the exit would increase the chances of debt default.

Despite a carefully prepared bailout for Ireland, involving the European Union and the International Monetary Fund, as well as the U.K. and Sweden, financial markets remain unconvinced that this will boost confidence in the euro zone or resolve the funding problems of the 'peripherals'.

On the contrary, Italy discovered within hours of the bailout being announced that international investors remain very wary. The country may have raised the EUR5.5 billion it was seeking at auction at a relatively good yield, but appetite for the paper could hardly be described as enthusiastic.

The blame for continued contagion fears could be left at the door of the Ireland debt negotiators for not providing more funds at a cheaper rate that would have removed fears that Irish banks are still at risk from hefty bad loans despite the fact that they passed bank stress tests this summer.

This focus on banks hardly bodes well, especially given that banks in some other areas of the euro zone, including Spain, are more highly leveraged than those in Ireland.

If that isn't enough, the Irish bailout has also illustrated that more funds may yet be needed.

Economists at Barclays Capital estimate that bailouts for Portugal and Spain would cost a further EUR34 billion and EUR255 billion, respectively. This would hardly drain the EUR655 billion left in the EU/IMF stabilization fund after Ireland's bailout.

Nonetheless, fears that more funds might yet be needed for more bailouts remain. This raises the prospect of the German government having to seek more politically contentious permission from its own parliament at a time when the ruling coalition under Angela Merkel has already been weakened.

So, as Trichet and his cohorts gather later this week, the ECB president may well find that he has to abandon his former hawkish attitude and fall into line with Bank of France Governor Christian Noyer, who said this weekend that the ECB will keep its non-conventional measures as long as they are needed.

Of course, this is hardly good news for future inflation and could even damage investor confidence in German government bonds.

But, by steering clear of the exit, Trichet will avoid putting any more pressure on euro-zone financial markets that remain as fragile as ever after the Irish bailout.

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