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Euro faces ‘exit of the strong’

By Willem Buiter

During the summer there were a number of developments justifying optimism about the euro’s survival chances. Since late September, however, the euro area’s political leaders have done all they can to dash these hopes.

Among the positives were the decision to enhance the European Stability Mechanism, the rescue fund for troubled nations, allowing the recapitalisation of banks directly without going through the sovereign; the German constitutional court’s approval of the ESM; the emergence of a pro-European majority from the Dutch elections; and the European Central Bank unveiling its big but conditional bazooka, outright monetary operations (OMT).

And then it all went pear-shaped. Germany insists that any direct bank recapitalisation by the ESM be covered by a sovereign guarantee. The distinction between the ESM lending to the sovereign with the sovereign recapitalising its banks – creating an on-balance sheet sovereign liability – and the ESM recapitalising the banks directly but with a guarantee from the sovereign – creating an off-balance sheet contingent sovereign liability – is one of appearance only. Markets will see right through it.

Germany and its allies want the supervisory role of the ECB restricted to a small number of large, mainly cross-border banks. Systemic problems can be created by clusters of domestic banks, as demonstrated by the Landesbanken and cajas. In addition, Germany and the other supporters of a minimalist supervisory role for the ECB want to delay the start of its supervisory role and thus also the start of direct bank recapitalisation by the ESM. Finally, the German, Dutch and Finnish finance ministers argue that there should be no mutualisation by the ESM of sovereign debt incurred in past bank recapitalisations, including Spain’s. In the case of Ireland, which incurred about €63bn of sovereign debt recapitalising its banks, this significantly increases risks of an Irish sovereign default.

OMT support cannot be tested until a sovereign applies for it and all conditions are met, including that the country is on a suitable programme and compliant with the programme. Spain, the prime candidate, is doing all it can to delay the inevitable.

The conditions for Greece to stay in the euro area for more than a few months are not met. Greece is non-compliant with both fiscal austerity and structural reform conditionality, including privatisation. It is clearly desirable that the (excessive) fiscal austerity conditionality be fudged, but this requires funding – probably between €10bn and €15bn extra between now and the end of 2014, with additional substantial funding needed in the subsequent two years. The International Monetary Fund rightly argues for official sector burden sharing by Greece’s official creditors and by the euro-system. No material new money for Greece is likely to be voted by core euro area parliaments.

Chancellor Merkel’s official visit to Greece was, in my view, mainly for German domestic political-electoral consumption and to obtain a German alibi for “Grexit”. The ECB argues that any voluntary burden sharing by the euro-system would constitute direct financing of the sovereign and is against the law. Greece, then, will exit the euro unless it achieves a de-facto write off of the around €300bn remaining sovereign debt. To remain compliant with European law, the ECB/euro-system will have to pretend to be a holdout in any debt restructuring.

With the Greek general government expected to run a small primary surplus next year, there is hope of an economic rebirth, provided Greece gets serious about structural reform of its labour markets, its professions, its bloated public sector, its tax administration and public expenditure management.

To save the euro, a faster move towards full banking union is needed.

This means the ECB becomes supervisor of all euro area banks, there is a single eurozone-wide bank resolution regime and one deposit guarantee regime and fund, covering redenomination risk, too. Banking union is necessary to restore the eurozone’s monetary transmission mechanism, destroyed by pernicious feedback loops between weak sovereigns and banks and national banking supervisors in the core imposing de facto capital controls disguised as prudential regulation.

Also necessary to save the euro and create the conditions for a resumption of growth is a restructuring of the debt of the most likely insolvent sovereigns – Greece, Portugal, Ireland, Cyprus and possibly Spain, Italy and Slovenia. Austerity fatigue in the periphery and growing bailout fatigue in the core mean that the ECB/euro-system is the only Santa Claus capable of filling the solvency gaps of sovereigns and banks in the euro area. However, any attempt by the ECB/euro-system to play this role on a sufficient scale to make a material difference would cause an exit of the strong, who reject the ECB as an open ended Santa. The coming year will be a lively one.

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