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Global Economics View

Three bits of good and one piece of bad news about Europe

Willem Buiter
+44-20-7986-5944
willem.buiter@citi.com

With thanks to
Juergen Michels, Ebrahim Rahbari and Deimante Kupciuniene

- Recent weeks brought three bits of good news and one piece of bad news for the euro area.
- The good news was:
  - I) the introduction of the ECB's Outright Monetary Transactions (OMT) facility,
  - ii) the decision of the German Constitutional Court to allow German participation in the ESM with small additional conditions,
  - and iii) the strong performance of centrist, pro-European parties in the Dutch election.
- The bad news was that differences between Germany (and allies) on one side, and France (and allies) on the other on certain aspects of banking union are becoming increasingly obvious. The latest disagreement is over whether all or only systemically important or cross-border banks should be supervised by the ECB.
- The OMT's main contribution is that it reduces the tail-risk of near-term sovereign default and euro area (EA) break-up as a result of a cut-off of market funding due to exit fear contagion and fears of break-up.
- In our view, the OMT does not materially change: i) the medium-term risk of sovereign debt restructuring in the euro area (we expect debt restructuring of some form at least in Greece, Portugal and in Ireland unless it can remove a significant part of its bank bail-out from the sovereign balance sheet), ii) the probability of Greek euro area exit (which we still see at 90% over the next 12-18 months), iii) the medium-term probability of wider euro area break-up (which we continue to consider to be low).
- We also continue to expect Spain and Italy to request an EFSF/ESM programme for the respective sovereigns. For Spain, it could come as early as the end of September, but is more likely to follow the regional elections on October 21. Italy's request is likely to be after Spain's, and could either precede or follow the general elections that are meant to take place by April 2013 at the latest.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Three bits of good and one piece of bad news about Europe

Recent weeks brought three bits of good news and one piece of bad news for the euro area. The good news was:

i) the introduction of the ECB's Outright Monetary Transactions (OMT) facility,

ii) the decision of the German Constitutional Court to allow German participation in the ESM with small additional conditions,

and iii) the strong performance of centrist, pro-European parties in the Dutch election.

The bad news was the continuing disagreement between Germany on one side, and France on whether all EA banks or only systemically important or cross-border banks should be supervised by the ECB.

The arrival in September 2012 of 4 bits of news about developments in the euro area sovereign and banking crisis, with the good news unexpectedly outnumbering the bad three to one, has caused policy makers, markets and pundits to heave a sigh of relief. This note argues that the sense of relief is not misplaced – up to a point, but that even just reaching the end of the periodic financial market "cardiac arrest" phase of the sovereign and banking crisis will still take at least two to three years. And even existential risks have been reduced but not eliminated.

The three bits of good news are (1) the announcement on September 6, 2012 by the President of the European Central Bank (ECB), Mario Draghi of Outright Monetary Transactions (OMT), the successor of the ECB's Securities Markets Programme (SMP); (2) the decision on September 12, 2012 by the German Federal Constitutional Court in favour of the ESM; and (3) the outcome of the Dutch parliamentary elections, also on September 12, 2012, which broke with a pan-European trend towards a weakening of the centre, a strengthening of extremist political parties of the left and right and the growth of anti-euro and anti EU sentiment. The bad news is the continuing disagreement between Germany on the one hand and France, the European Commission (and probably the ECB as well) on the scope of the ECB's supervisory role in euro area (EA) banking supervision, and on the speed with which progress towards banking union in the EA can be expected.

OMT eliminates a key tail risk

On September 6 ECB President Draghi announced a new conditional sovereign debt purchase instrument: Outright Monetary Transactions (OMT)[1]

On September 6 the President of the ECB, Mario Draghi announced a new conditional sovereign debt purchase instrument: Outright Monetary Transactions (OMT)[2]. It also relaxed its collateral requirements. Debt issued by or guaranteed by sovereigns that are beneficiaries of OMT and compliant with the relevant programme conditionality (see (6) and (7) below) can be offered for repo with no minimum credit or rating requirements. This measure institutionalizes the policy used for the existing programme countries on an ad-hoc basis and widens the collateral pool.

1. OMT purchases are *ex-ante* unlimited in size.

2. The ECB will be 'pari passu' with private and other creditors for its OMT purchases.[3]

3. Interventions are in the secondary markets only (primary market purchases of sovereign debt by the central bank are forbidden by the Treaty).

4. As a rule, sovereign debt with remaining maturity of one to three years will be purchased.[4]

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[1] Please see *"Euro Economics Weekly - OMT: Unsheathing the Latest Weapon in the ECB's Armoury"*, Guillaume Menuet et al, 7 September 2012, Citi

[2] Please see *"Euro Economics Weekly - OMT: Unsheathing the Latest Weapon in the ECB's Armoury"*, Guillaume Menuet et al, 7 September 2012, Citi

[3] "The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds." http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html)

5. The ECB wants company: it will engage in OMT operations only if the EFSF/ESM intervenes in the primary sovereign debt markets at the same time.

   This interpretation is contested. The press release by the ECB on the OMT only required the *possibility* of such purchases by the EFSF/ESM to be present.[5] However, Draghi's statement following the September 9, 2012 ECB Governing Council meeting appears to indicate that EFSF/ESM interventions are likely to be required for OMT to be activated: *"At the same time, governments must stand ready to activate the EFSF/ESM in the bond market when exceptional financial market circumstances and risks to financial stability exist – with strict and effective conditionality in line with the established guidelines. The adherence of governments to their commitments and the fulfillment by the EFSF/ESM of their role are necessary conditions for our outright transactions to be conducted and to be effective."*

6. OMT purchases will be sterilised – they will not increase the monetary base.

7. OMT purchases will be made only if the ECB is satisfied that the beneficiary sovereign is on an effective programme and is, in the view of the ECB, compliant with that programme. Eligible programmes include the troika programmes that Greece, Ireland and Portugal are on, or MoU-based EFSF/ESM programmes or Precautionary programmes like the ESM ECCL (Enhanced Conditions Credit Line).

8. If a beneficiary country on a programme violates the conditionality of the programme, the ECB will stop the asset purchases. Jörg Asmussen, the German member of the Executive Board of the ECB, went one further and suggested that the ECB could, under these circumstances, even decide to sell some or all of the sovereign's debt it had purchased earlier.

9. Involvement of the IMF is welcomed, but not required to operate the OMT.

10. The sovereign funding part of the SMP is closed down. This is not completely irrelevant, as the SMP has no maturity restrictions on its purchases of sovereign debt, unlike the OMT.

11. For the OMT, information on the aggregate holdings and their market values will be published on a weekly basis. In addition, the breakdown by country and the average duration of OMT holdings will be published each month.

The planned size or leverage ratio of the ECB OMT interventions and any yield or spread target have not been specified.

Two important characteristics of the OMT have not been spelt out (and may never be spelt out). The first is the ratio of the sizes of the interventions under the OMT and EFSF/ESM purchases (effectively the leverage ratio for the EFSF/ESM primary market purchases), but is clearly crucial given the limited and indeed inadequate resources at the disposal of the EFSF/ESM. We doubt whether the average effective leverage ratio (ratio of OMT purchases in the secondary markets to EFSF/ESM purchases in the secondary markets plus any EFSF/ESM direct lending to the sovereign) will exceed 4. Having the IMF on board as a source of funds, as well as a source of wisdom, will therefore be highly desirable given the limited resources available to the EFSF/ESM).

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[4] "Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years." http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html)

[5] "Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases." ECB Press Release, 12 September 2012

The second is the level of yields and spreads that is targeted or that is a trigger for ECB OMT interventions. ECB President Draghi has repeatedly emphasized that the OMT is in particular meant to reduce (possibly extinguish) foreign exchange rate risk premia, based on fears of EMU break-up. Undoubtedly, such break-up fear induced forex risk premia have contributed to the sharp increase in sovereign bond yields of, inter alia, Italy and Spain since mid-2011 up until the series of ECB announcements starting with ECB President Draghi's speech in London on July 26, 2012. However, credit risks orthogonal to break-up risks have likely also contributed to the run-up in yields and the ECB has been notably quiet on this issue – even though in the context of the programme, the fiscal austerity and structural reform conditionality is meant to take care of debt sustainability concerns. A related issue is how to operationalise the idea of foreign exchange rate risk premia to define entry points for intervention. Such an approach will necessarily involve a heavy dosage of judgement by the ECB Governing Council, but the analytical input is likely to define the foreign exchange risk premia as a measure of ignorance – the difference between actual market yields and a 'fair value' based on observable fundamental risk factors, including economic growth, government deficit and debt levels, indicators of private sector balance sheet health, etc.[6]

OMT has eliminated the tail risk that fiscally and competitively weak but OMT-compliant EA countries are involuntarily driven out of EA through a cut-off of market funding.

The tail risk that is eliminated by the OMT is the risk that fiscally and competitively weak but OMT-programme-compliant EA countries can be driven out of the EA against their will through a cut-off of market funding for sovereigns and/or banks. Specifically, the creation of the OMT rules out involuntary exits of programme-compliant EA member states through a sudden stop on funding driven by exit fear contagion following a Greek exit from the EA (which we still expect with a very high likelihood to occur over the next 12 two 18 months, probably early in 2013). The sovereign would get funded through the OMT and the banks through some combination of LTROs or shorter-duration refinancing operations which the ECB is able to set up in due course. By an *involuntary* exit of a country from the EA we mean an exit driven by a cut-off of concessional funding (by the troika, or by the EFSF/ESM combined with the OMT) to the sovereign and a cut-off of Eurosystem and Emergency Liquidity Assistance (ELA) facility funding for the banking sector of that country.

A country that is not programme-compliant can (in our view, will) ultimately be cut off from official funding sources for its sovereign and will thus be forced into sovereign default. Until we have EA banking union with an EA bank resolution and recapitalization fund and with mutualised guarantees for insured retail deposits, sovereign default will likely push the banking systems of most periphery member states into (near-) insolvency in our view. It is certainly likely that, following a sovereign default, the nation's banks will only be able to fund themselves at the Eurosystem or the national ELA. If bank funding from the Eurosystem and the ELA is also cut off, non-programme compliant countries can still be forced involuntarily out of the EA. With banking union, it is likely that sovereign debt restructuring and bank debt restructuring would take place in the EA. It is even possible that, should a national government be cut off from further participation in OMT because of failure to comply with programme conditionality, the banks of that nation might still be able to fund themselves at the Eurosystem or the national ELA, thus avoiding the need for exit from the EA. The sovereign would default/restructure inside the EA, like Greece in 2012.

[6] For one recent attempt at computing fundamentally based levels of sovereign yields, see Di Cesare et al (2012), "Recent estimates of sovereign risk premia for euro-area countries", Bank of Italy Occasional Paper No 128, September 2012, http://www.bancaditalia.it/pubblicazioni/econo/quest_ecofin_2/qef128/QEF_128.pdf

OMT design is meant to increase the 'bang for the buck' of ECB interventions.

Giving up seniority by the ECB may well backfire.

The different characteristics of the OMT programme, in particular forgoing seniority, the explicit reference to the lack of ex-ante limits, and additional information provided, appear in our view to be targeted to increase the 'bang for the buck' of ECB interventions to affect market yields, i.e. to increase the effect on market outcomes for any given amount of ECB purchases or balance sheet increase – ostensibly meant, in our view, to reduce the amount of purchases that would actually need to take place, ideally to zero. While many of these aspects make sense, including the increased use of 'open mouth operations' even though the ECB fell short of specifying yield targets, one is not: forgoing seniority for ECB purchases appears ill-advised, in our view. With ECB seniority (*de facto* or *de jure*) OMT purchases would reduce probabilities of default for the sovereign whose bonds are being purchased, but a lower recovery rate for private investors in the case of default. Giving up seniority will increase the recovery rates for private investors relative to the alternative, but may adversely affect the probability of default. The reason is that giving up seniority implies that the ECB itself is exposed to more credit risk. The increase in balance sheet exposure of the ECB could then make it more timid in deploying its firepower – and therefore the credibility of the 'unlimitedness' statement.[7] The OMT programme does have two elements that are meant to reassure the ECB that it is not taking on undue amounts of credit risk – the conditionality that comes with the EFSF/ESM programme, and the fact that purchases target short maturities – but that reassurance is likely to be imperfect, particularly in the early stages of the use of the facility, before Italy and Spain can have established a track record of fiscal austerity and structural reform. A second risk of giving up seniority is that while the ECB speaks of no limits to its ex-ante exposure, it could increase the likelihood of ex-post unlimited exposure. In that case, the risk that the core of the EA would leave could increase.

Despite the existence of the OMT, there remains the risk that political events, such as the strengthening of anti-bailout sentiment in the core countries, could force a stop to the funding of the periphery countries. This could manifest itself through a refusal to provide funding through the fiscal facilities (the EFSF and the ESM) and/or through pressure from the core countries on the ECB to limit or end its funding of periphery sovereigns and/or banks. As regards the fiscal facilities, even within the existing total funding envelope of €500bn, adding a new country programme will require the unanimous non-objection of all 17 member states (or their delegates on the Board of the ESM). Should the ECB and the European Commission jointly opine that a programme is essential for the survival of the euro, the qualifying majority goes down to 85 percent. A more likely obstacle to future fiscal funding will come when the fiscal facilities are exhausted and 17 EA member state governments and parliaments will have to agree on an increase in resources.

The Treaty-based independence of the ECB makes it unlikely that direct pressure would be brought to bear by national political leaders on the Executive Board and the Governing Council. There is, however, a tendency for some of the national central bank (NCB) Governors to act as national delegates rather than independent parties for whom only the ECB's mandate matters. In addition, the risk that excessive debt purchases by the ECB/Eurosystem (through the OMT or other mechanisms) would lead to a strong political response from the backbenchers in the core member states' parliaments and from vocal and influential parties in the wider polity and in the media. The threat that 'Weimarisation' of the ECB/Eurosystem balance sheet could trigger an exit from the euro by the core members will act as a constraint on how much sovereign debt the ECB can purchase. It also means, as noted already, that it is likely that countries that are non-compliant with programme conditionality will indeed be cut off from further participation in the OMT in our view.

[7] In Global Economics View - Did Summit Avoid Nadir?, we similarly argued that it would be mis-guided for the ESM to give up seniority except for direct bank recapitalizations.

The OMT has much less effect on the risk (low in our view), that a fiscally and competitively weak EA member state would decide to walk out of the monetary union voluntarily.

The OMT has much less of an effect on the risk (low in our view), that a fiscally and competitively weak EA member state would decide to walk out of the monetary union voluntarily. This could occur if a populist, nationalist, anti-euro and probably anti-EU government were to take office in one of the EA periphery countries (Greece, Portugal, Ireland, Spain, Italy, Cyprus and Slovenia) and decide that less or less painful austerity and structural reform would be achievable outside the EA, and/or that a swift, less painful and lasting improvement in real competitiveness could be achieved through a sharp devaluation vis-à-vis the euro of a new national currency.

The OMT somewhat increases the risk of a voluntary exit, in our view, of the fiscally and competitively stronger countries of the core EA (both hard and soft).

The OMT somewhat increases the risk of a voluntary exit in our view of the fiscally and competitively stronger countries of the core EA (both hard and soft), especially Germany, Finland, Luxembourg, Austria, Slovakia, the Netherlands, Belgium, France, Estonia and Malta. This is because there is a risk (small in our view), that the extent of backdoor mutualisation of EA periphery sovereign debt through the OMT would be greater than the tolerance limits in Germany, Finland, the Netherlands and Austria especially, for creating a limited transfer Europe through the ECB/Eurosystem. It is clear that there is no political appetite in these four countries, for open-ended, uncapped sovereign debt mutualisation either through the fiscal facilities (Greek Loan Facility, EFSF and ESM) or through the ECB/Eurosystem. We believe any form of open-ended, uncapped one-sided transfer Europe without a prior or at least simultaneous quid-pro-quo in the form of a material surrender to the supranational level of national fiscal, regulatory, supervisory and other wide economic policy sovereignty, could lead to an exit by the hard core, who could then create a new greater DM zone.

The OMT facility will not deliver unlimited, open-ended or uncapped mutualisation of EA sovereign debt, but it will result in *some,* possibly significant, mutualisation over and beyond what seemed likely prior to its creation.

The OMT facility will not deliver unlimited, open-ended or uncapped mutualisation of EA sovereign debt. It will, however, result in *some,* possibly significant, mutualisation over and beyond what seemed likely prior to its creation. The upper bound to the mutualisation tolerance threshold of the majority of the ECB Governing Council is given by the non-inflationary loss absorption capacity of the Eurosystem. According to our estimates, this could easily be as high as €3 trillion (see Buiter (2010) and Buiter and Rahbari (2012a,b). The total outstanding EA periphery general government debt at the end of 2011 was just over €3.4 trillion.[8] In principle, this means that the 7 periphery countries could retire their entire existing debt (except the €210bn or so already held by the Eurosystem as a legacy from the SMP) and replace it with EA periphery sovereign debt with a remaining maturity of 3 years or less. This could all be bought by the ECB as long as the countries in question are on ECB-approved programmes and compliant with the conditionality. Recognising this, Maria Draghi has made it clear that the ECB does not want to see a significant shift in issuance to the short end of the maturity structure.[9] The Governor of the Belgian central bank, Luc Coene, has even suggested that the debt purchased by the ECB under the OMT would be of 3-years maturity only, thus excluding all maturities shorter than three years.[10] [11] If all this EA periphery sovereign debt were then defaulted on, and assuming a recovery rate on EA

[8] Source: Eurostat. The EA periphery is defined as Greece, Portugal, Ireland, Spain, Italy, Cyprus and Slovenia.

[9] ECB, Introductory statement to the press conference (with Q&A)Mario Draghi, President of the ECB, Vítor Constâncio, Vice-President of the ECB,Frankfurt am Main, 6 September 2012 http://www.ecb.int/press/pressconf/2012/html/is120906.en.html

[10] FT Alphaville, The OMT and 'Limits', 18 September 2012, http://ftalphaville.ft.com/blog/2012/09/18/1166021/

[11] This appears inconsistent with the words of Mario Draghi in an interview with the Süddeutsche Zeitung on September 14, 2012, *"Moreover, the Outright Monetary Transactions will focus only on the shorter term, in particular on bonds with a maturity of one to three years."* http://www.ecb.int/press/key/date/2012/html/sp120914.en.html

sovereign debt close to the historical average of sovereign defaults of 50 percent (a number consistent with the average recovery rate for sovereign defaults since 1983 in Moody's (2012)), the ECB would suffer a loss of €1.7 trillion – well inside its non-inflationary loss absorption capacity.[12]

We believe that the actual binding constraint on the ECB's willingness (as opposed to its capacity) to absorb losses is probably quite a bit less than $1.7 trillion, but even €1.0 trillion would provide material assistance to the periphery sovereigns.

The actual debt held de facto or de jure guaranteed by the sovereigns in the EA periphery is likely to increase rapidly if the deterioration of the financial circumstances of their banks continues. Both the belated recognition of legacy losses and the accretion of new losses because of the recessions, often deep, in many of the EA periphery member states, make it wise to consolidate the accounts of the sovereign and the accounts of the banks and other systemically important financial institutions in their national jurisdictions. Our best estimate of the size of the balance sheets of Monetary Financial Institutions (MFIs) excluding the Eurosystem balances in the EA periphery is €10.4 trillion at the end of July 2012.[13] Non-inflationary mutualisation of sovereign and bank debt from the EA periphery by the ECB/Eurosystem is therefore highly unlikely to be even just technically feasible. It would be politically infeasible in our view. We return to this issue below.

Lasting impact of the OMT will likely require that fiscally weak countries actually agree on a programme and ECB actually starts its purchases.

Finally, despite the confidence bounce in financial markets following the announcement of the OMT, which has resulted in lower sovereign and other rates in the periphery at all maturities, and especially at the shorter end – a bonus obtained without the ECB actually spending any money or another EA member state making itself eligible for OMT support by going on a programme, there will only be a lasting impact if the key countries (at the moment Spain and Italy) actually agree on a programme with the EFSF/ESM (and possibly with the IMF also). We expect this to happen soon.

We still expect Spain and Italy to request an ESM programme, with Spain likely going first.

The Spanish government may apply for a programme as early as the end of September 2012. It is likely to formally contain no additional substantial fiscal austerity or structural reform conditionality, but strict timetables of concrete measures that will be monitored by outside parties.[14] It is possible that the Spanish government will try to postpone the request for a programme till after the October 21, 2012 regional elections in Galicia and the Basque country. In view of the failure of its previous attempt to influence regional election outcomes in its favour by postponing the announcement of unpopular news (the Spanish government delayed announcing the full 2012 budget in March until after a regional elections in Andalusia and Asturias without this producing the desired electoral outcome), trying to influence the elections may not be a wise strategy this time.

[12] Moody's (2012) states that for the 16 sovereign defaults it considered between 1998 and 2012H1, the Issuer-Weighted Recovery Rates were 51% of Par based on the Average Trading Price methodology and 64% according to the methodology based on the PV Ratio of Cash flows. The corresponding recovery rates for Value-Weighted recovery rates were 25% and 31% respectively.

[13] Source: ECB

[14] On September 28, the Spanish government is expected to announce a range of additional structural reforms that are meant to address the main issues raised by the IMF and the European Commission in their recent assessments (Article IV for the IMF, for the Macroeconomic Imbalance Procedure for the EC). Following the announcement of these structural reforms, the EFSF/ESM programme that we expect is then unlikely to require substantial further measures, but is likely to insist on timely implementation.

The Italian government will no doubt wish to wait until after Spain has gone onto a programme before swallowing the bitter medicine itself. Unless the markets force the issue, the current administration may well prefer to leave the decision to the next government – general elections are due no later than April 2013, and could happen earlier, say in February. However, should the polls indicate that the next Italian government might be influenced significantly be the views of anti-austerity, anti-structural reform, anti-euro parties with a tendency towards nostalgia for the lira, then Premier Monti may well be tempted to constrain his successor by applying for a programme before the elections.

The markets may, for a wide range of fundamental or spurious reasons, lose confidence faster than currently anticipated, making market access without OMT support prohibitively expensive. In addition, the ECB itself can always force a country into a programme if that country's banks depend overwhelmingly for funding on the Eurosystem and/or the ELA. The Irish government responded to the implied threat to continued Eurosystem/ELA funding for its banks by applying for a troika programme on 21 November 2010, even through the sovereign itself (but not its banks) were funded until well into the Spring of 2011. Should the ECB want to see all seven periphery EA member states on programmes prior to the eruption of the financial turmoil that would inevitably result from Grexit, if it were to occur, the reluctant programme applicants may well get 'encouragement ' to apply from the ECB similar to that received by Ireland.

The Bundesverfassungsgericht strikes two blows for the euro.

On September 12, the German Constitutional Court ruled that German participation in the ESM was admissible, subject to two relatively weak additional conditions.

On September 12, the German Federal Constitutional Court in Karlsruhe ruled in favour of the ESM – the permanent fiscally backed liquidity fund for sovereigns and capital fund for banks in the EA.[15] Rather surprisingly, it imposed only minimal further conditions as regards German parliamentary oversight over German's exposure to the ESM. All it demanded was that any increase in German exposure beyond the current ceiling of €190bn (out of ESM capital of €700bn total) had to be approved by the German Representative on the Board of the ESM, that is, effectively, by the Bundestag.[16] [17]

The second condition it imposed was rather more interesting. And despite the confidentiality of the ESM's deliberations, it insisted that the German Parliament have access to all the information it required to keep the ESM accountable to the German Bundestag and Bundesrat for the German exposure under the ESM.[18] In

[15] See "*Germany - Court Gives Green Light for ESM Participation Under Conditions*", Juergen Michels, 12 September 2012, Citi

[16] "…the provision under Article 8 paragraph 5 sentence 1 of the Treaty establishing the European Stability Mechanism limits the amount of all payment obligations arising to the Federal Republic of Germany from this Treaty to the amount stipulated in Annex II to the Treaty in the sense that no provision of this Treaty may be interpreted in a way that establishes higher payment obligations for the Federal Republic of Germany without the agreement of the German representative;…" Extracts from the decision of the Federal Constitutional Court of 12 September 2012, http://www.bverfg.de/en/decisions/rs20120912_2bvr139012en.html .

[17] The current limit on ESM capital is €700bn. This provides it with AAA funding capacity of €500bn.

[18] "… the provisions under Article 32 paragraph 5, Article 34 and Article 35 paragraph 1 of the Treaty establishing the European Stability Mechanism do not stand in the way of the comprehensive information of the Bundestag and of the Bundesrat." Extracts from the decision of the Federal Constitutional Court of 12 September 2012, http://www.bverfg.de/en/decisions/rs20120912_2bvr139012en.html .

the short run, this will, like any demand for openness, transparency and accountability, be an irritant to those managing the ESM and to the EA political leadership. It will slow down the decision making process and make it more cumbersome. However, it may also permit the arrangement to survive in a Europe where unaccountable, technocratic solutions to the euro area's woes are becoming increasingly unpopular. Unless the steady transfer of traditional national competences (all of monetary policy, parts of fiscal policy, banking supervision, banking regulation, bank resolution) to the supranational level is accompanied by a matching increase in effective democratic accountability, transparency, openness and oversight, the legitimacy of the new institutions and indeed the old (the European Commission and the ECB, for instance), will be questioned more and more openly and vigorously in our view. Unless the new emerging EA is much more democratic and accountable than the existing EU, it is unlikely – for purely political reasons - to survive. The German constitutional court did Europe and the EA a favour by firing this warning shot.

The Constitutional Court also enunciated on an issue that is likely to be beyond its legal competency – namely that ECB secondary market purchases of EA sovereign debt were against the Treaty if they were meant to help finance those governments.

The German Federal Constitutional Court surprised many when it also enunciated on an issue likely to be beyond its legal competency. The Court's argument is that purchases by the ECB of government debt are banned by the Treaty because they amount to monetary financing. *"For an acquisition of government bonds on the secondary market by the European Central Bank aiming at financing the Members' budgets independently of the capital markets is prohibited as well, as it would circumvent the prohibition of monetary financing (see also Recital 7 of Council Regulation (EC) No 3603/93 of 13 December 1993 (OJ L 332 of 31 December 1993, p. 1)). This is taken account of by the Treaty establishing the European Stability Mechanism, whose Recital 4 calls for strict observance of the European Union framework, the integrated macroeconomic surveillance, in particular the Stability and Growth Pact, the macroeconomic imbalances framework and the economic governance rules of the European Union. Article 123 TFEU is one of these rules."*

As regards form, the Treaty on the Functioning of the European Union, to which Germany is of course a signatory, makes the European Court of Justice the supreme arbiter of legal matters involving just EU institutions.[19] The matters pertaining to what the ECB does or does not do, unlike matters involving the ESM, are not part of the German Federal Constitutional Court's remit. They fall under the European Court of Justice in Luxembourg. Even though the German court is aware of this and even said so in its statement, it seems unusual to then proceed and comment on a matter out of its jurisdiction anyway.[20] As regards substance, both a cursory and a deep reading of Article 123 TFEU make it clear that the article says nothing about monetary financing. Monetary financing concerns the liability side of the balance sheet of the central bank. Article 123 TFEU exclusively puts restrictions

[19] Article 263 TFEU (ex Article 230 TEC) states:

The Court of Justice of the European Union shall review the legality of legislative acts, of acts of the Council, of the Commission and of the European Central Bank, other than recommendations and opinions, and of acts of the European Parliament and of the European Council intended to produce legal effects *vis-à-vis* third parties. It shall also review the legality of acts of bodies, offices or agencies of the Union intended to produce legal effects *vis-à-vis* third parties.

It shall for this purpose have jurisdiction in actions brought by a Member State, the European Parliament, the Council or the Commission on grounds of lack of competence, infringement of an essential procedural requirement, infringement of the Treaties or of any rule of law relating to their application, or misuse of powers.

[20] See Extracts from the decision of the Federal Constitutional Court of 12 September 2012, http://www.bverfg.de/en/decisions/rs20120912_2bvr139012en.html

on the asset side of the balance sheet of the central bank.[21] It bans overdraft facilities or any other type of credit facility with the ECB or the NCBs for any member state government institution and for Union institutions and direct purchases of government debt by the ECB and NCBs. This suggests the desirability of Basic Law and TFEU amendments banning bodies that don't know debit from credit to rule on matters that depend crucially on that distinction.

Even in the passages of the German Federal Constitutional Court's decision of 12 September, 2012, there is no statement to the effect that the total (€190bn) exposure limit of the German sovereign to sovereigns in the rest of the EA refers not to the ESM alone but to the sum of the ESM exposure and the OMT purchases by the ECB, assertions by Horst Seehofer (the Bavarian PM) and Peter Gauweiler, a member of the Bundestag from the Bavarian CSU, notwithstanding.[22]

Dutch courage

On September 12, centrist pro-European parties registered a strong performance at the Dutch general elections, reducing the risk that the Netherlands would be an impediment in the process of agreeing on additional support measures for fiscally weak EA countries if and when needed.

Third, the Dutch parliamentary elections of 12 September 2012 saw a reversal (at least a local one) of the European trend towards political polarisation and the growth of right-wing and left-wing anti-bail-out and often anti euro and anti-EU extremism. The new government will be a pro-European, pro-conditional-bail-out government of the centre-right and centre-left. This eliminates two risks.

The first is that a new Dutch coalition government might have depended for its parliamentary survival on the support of the anti-bail-out parties of the extreme right and left. This could have forced the government to vote against proposals in the Eurogroup and the European Council, for the likely forthcoming programmes for Spain, Italy, Cyprus and Slovenia. Abstention instead of an active veto could have saved the day here, as the EFSF and, under its normal operating procedures also the ESM, require the unanimous non-objection of the 17 AE member states, not their unanimous approval. In addition, if the European Commission and the ECB were to jointly agree that a programme is essential for the survival of the euro, the unanimity principle for approval is replaced by an 85% qualified majority, as the emergency facility can be used.

The second and greater risk is that a Dutch government that depends for its survival on the anti-bailout parties would have had serious problems supporting an increase in the size of the ESM. Even if there are 'no step-out countries' (beneficiaries from the ESM that have some contributions waived as a result), the maximum amount of funding the ESM can ultimately support under the current Treaty is €500bn. This is supposed to be used both to recapitalise banks (after a single European banking

[21] Article 123 TFEU (ex Article 101 TEC)

1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

[22] Open Europe Blog, 17 September 2012: http://openeuropeblog.blogspot.co.uk/2012/09/merkel-caught-in-middle-between.html ; and Eurointelligence, "A new legal case against ESM – that links Draghi's OMT to the current case", 10.09.2012; http://www.eurointelligence.com/eurointelligence-news/news/singleview/article/a-new-legal-case-against-esm-that-links-draghis-omt-to-the-current-case.html?L=0&cHash=8e39802868889130252d9c296389045f .

supervisor is created and probably further conditions have been met) and to make loans to sovereigns and/or purchase their debt in the primary or secondary markets. Of the €500bn, €100bn is earmarked for future Spanish bank recapitalisation. If Ireland retroactively gets full mutualisation of sovereign debt issued to recapitalise its banks, that would require another €64bn. Equivalent treatment for Greece would cost €45bn and for Portugal €8.5bn. That would leave €282.5bn, a pittance compared with the likely future funding needs of Spain and Italy, unless the ECB does most of the heavy lifting through the OMT.

German and other core EA scrutiny of the ECB's OMT purchases will likely limit severely the extent to which the OMT can leverage the ESM. Even through Chancellor Merkel is no doubt quite happy to get any assistance from the ECB that is available, she is constrained by her less flexible coalition partners and by German public opinion. So will the threat of a resignation by Jens Weidmann, the President of the Bundesbank, who is convincingly playing the German 'bad cop' role vis-à-vis bail-outs, with ECB's Executive Board member Jörg Asmussen playing the role of 'good cop'.

Banking Union at risk of delay and of being watered down

The bad news is the continuing disagreement between Germany on one side, and France on whether all EA banks or only systemically important or cross-border banks should be supervised by the ECB.

Not all is sunshine, however. The European Commission's proposal for a single supervisory mechanism for banks under the overall control and authority of the ECB is running into German resistance. Germany wants to keep national control over its regional banks (Landesbanken) and local banks (Sparkassen) and co-operative banks (Volksbanken). These institutions have been widely criticized in the press for engaging in dubious lending practices, and haven often appeared to be instruments of regional politics rather than profit-oriented financial institutions.

Because without banking union (a single EA-wide supervisor for all banks; rapid convergence of banking regulations among the 17 EA member states; a single bank resolution regime/authority and an associated resolution and recapitalisation fund; and a single EA-wide deposit insurance scheme and fund), the euro area cannot survive in our view, speedy progress is essential. Without the first step (the single supervisory mechanism (SSM) that Germany is now trying to emasculate), the next step – the ESM as bank recapitalisation fund and proto-bank resolution fund, cannot take place.[23] This is extremely serious. National supervisors in the core EA nations have, under the guise of prudential regulation, imposed de facto capital controls on interbank flows from the core to the periphery, including flows between subsidiaries of the same cross-border bank and between subsidiaries and parent. This results in cross-border bank X lending in South Tirol (Italy) to corporate clients at rates 350bps higher than for comparable corporate risks in North Tirol (Austria). When the Austrian subsidiary tries to send funds to its Italian parent it is stopped by the Austrian supervisor/regulator. With banking union, and with the ECB in charge of supervision, it will come down heavily on capital market "balkanizing" national supervisors, whose actions destroy the monetary transmission mechanism in the euro area.

[23] See "*Global Economics View - Three unanticipated consequences of banking union*", Willem Buiter, 2 April 2012, Citi

Conclusions and implications for markets

We expect market concerns about the EA support framework to return, possibly as a result of concerns about Grexit or programme requests in Spain or Italy.

For the moment the markets are pleasantly surprised with what has been achieved. We expect this glow to wear off eventually. Potential triggers could be the troika report on Greece, even though the expected arrival date for the report continues to slip, with some not expecting the report until November), or as first Spain (possibly not until after the regional elections on October 21) and then Italy actually sign up for the OMT.

The ECB's OMT has not materially altered the probability of Grexit, which we continue to put at 90%.

The possible exit of Greece from the EA is not made less likely through the most recent developments. We have therefore retained our assessment that the probability of Grexit is 90% over the next 12-18 months, and we believe the most likely date is in the next 2-3 quarters.[24]

Because there is simply too much debt in the EA as a whole (private and public), mutualisation of enough of the excessive private and public debt of the periphery to restore the solvency of the sovereigns and of the systemically important private entities is not possible in our view.

We do not see a major role for growth or inflation in resolving the problem of excessive public and private sector debt in many EA countries.

Growth will not solve the EA debt problem in our view; excessive debt and the feasible conventional restrictive public and private responses to it will instead keep growth low unless and until another way of deleveraging can be found. We don't think inflation will solve the EA debt problem. Unlike the Fed and the Bank of England, for whose leadership the Great Depression of the 1930s is the 'Defining Moment', the 'Defining Moment' of most continental European central banks is the Weimar hyperinflation and the other hyperinflations of the 1920s. They will not deliberately create inflation to reduce the real burden of the excessive public and private debt in our view.

Instead, we are likely to see some ex-post mutualisation of sovereign and bank debt and a number of sovereign and bank debt restructurings.

We will see some ex-post sovereign debt mutualisation and some mutualisation of bank debt that will migrate to the national sovereign's balance sheet or to that of the ESM. This will occur both through fiscal losses on the Greek Loan Facility, the EFSF and the ESM (explicit official sector involvement or OSI) and through backdoor quasi-fiscal mutualisation of sovereign debt and bank debt/loans by the ECB/Eurosystem.

We expect sovereign debt restructuring in Greece and Portugal, and in Ireland, unless Ireland can remove a substantial part of its bank bail-out from the sovereign balance sheet.

Sovereign debt restructuring in Spain or Italy is a material risk, but not our base scenario.

We are still likely to see multiple sovereign debt restructurings of EA periphery sovereigns, starting possibly with Greece and probably lasting into 2015. We expect Portugal will likely require sovereign debt restructuring, possibly in 2014-15, but could happen even earlier, both through OSI and through PSI (Private sector involvement). Unless Ireland benefits from major OSI, say in the form of a mutualisation through the ESM of up to €64bn worth of sovereign debt – the counterpart of the capital injection into its banking system provided by the Irish authorities between 2008 and 2010 – we believe it too is likely to see sovereign debt restructuring.[25] The Spanish sovereign and banking sector taken together are most likely insolvent. The relevant question then becomes what combination of mutualisation, bank debt restructuring and sovereign debt restructuring will occur. We already know of the first source of potential mutualisation – the up to €100bn of the Spanish bank bail-out that will originally be provided as a loan by the EFSF/ESM to the Spanish sovereign, but which could be transformed into ESM capital injections into Spanish banks once several conditions are met, including the ECB's function as a single supervisor of EA banks. We also know that there is going to be

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[24] Global Economic Outlook and Strategy - September 2012

[25] See "*Euro Economics Weekly - Ireland — Crucial Period Ahead*", Michael Saunders, 14 September 2012, Citi

bank debt restructuring. Unsecured creditors below the senior level are required to be bailed in when a Spanish bank has recourse to ESM funds. We expect that, as bank losses and government debt continue to grow, senior unsecured creditors too will have to be bailed in for some banks.[26] As regards the sovereign, its gross debt as a share of GDP is still at 76%, well below the EA average, even though it is rising fast and likely to catch up with the EA average soon. Three things would have to go wrong, in our view, for the Spanish sovereign to be unable to keep its creditors whole.

The first is that the banks' need for externally provided capital exceeds the €100bn available from the ESM by a significant margin. We believe this is quite likely, both through legacy hidden losses on residential mortgages and because of new losses on commercial, corporate and household loans as the Spanish economy continues to be mired in recession.

The second risk is that the Spanish central government will blink first in its confrontation with the 17 autonomous regions, some of whom refuse to follow the austerity mandate imposed on them by the central government.

The third risk is our suspicion that, like every other country where the central government imposed borrowing constraints on lower-tier authorities but forgot to forbid the granting of guarantees, Spain's autonomous regions, municipalities and social funds have created special purpose vehicles that borrowed when the lower-tier governments could not, that were guaranteed by these lower-tier authorities and that soon will have to move their unserviceable debts to the guarantors and hence to the central government.

A Spanish sovereign debt restructuring is, in our view, a material risk but not the most likely outcome at this point.

Italy should never suffer a sovereign default due to inability to pay in our view. It is a rich country with massive private wealth and, by the standards of the periphery, is in a relatively good economic shape, although massive structural reforms are required to get out of the swamp the country now finds itself in.[27] With the present administration, a sovereign default triggered by unwillingness to pay (rational default, strategic default or opportunistic default) is not a risk, despite the tempting configuration of a high debt burden (general government debt is more than 120 percent of GDP) and an actual and structural primary surplus. However, as pointed out in Buiter (2012), banking union, and the severing of the umbilical cord between banks and the national sovereign will somewhat tilt the cost-benefit of strategic default in favour of a possible default.[28]

For Italy, the key driver of sovereign risk will be domestic politics, and especially the nature of the next coalition government that will emerge following the general elections, no later than the end of April 2013. If the new government is pro-European, with a healthy majority and reasonably committed to fiscal austerity and structural reform, Italian sovereign debt probably will be safe. If instead it depends on the support of parties that are populist, anti-euro (even nostalgic for the lira), anti-austerity and opposed to radical structural reform, then Italian sovereign debt

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[26] See "*Global Economics View - What's Next for Spain and Italy?*", Willem Buiter and Ebrahim Rahbari, 25 June 2012, Citi

[27] See "*Global Economics View - What's Next for Spain and Italy?*", Willem Buiter and Ebrahim Rahbari, 25 June 2012, Citi, and "*Euro Economics Weekly - Focus on Italy*", Juergen Michels, 8 June 2012, Citi

[28] See also Global Economics View - Three unanticipated consequences of banking union, Willem Buiter, 2 August 2012

might not be safe. In Italy and in most of the rest of Europe, all economics has become macro and all macro has become politics.

The 'new normal' for how much sovereign debt in the EA is sustainably privately financeable is likely to be much lower than before the crisis.

Even though Italy and Spain are likely solvent, they will have for the foreseeable future ratios of (gross general government) debt to GDP that will exceed what is likely to be the 'new normal' for government debt in the euro area that can be financed sustainably by private investors. What the limit for privately financeable government debt is, is highly uncertain – neither theory nor empirical evidence give us much guidance in this regard. What we are left with then are focal points. One prime candidate for such a focal point is the 60% of GDP guideline for government debt that was one of the Maastricht criteria for entry into the Economic and Monetary Union (EMU). The Fiscal Compact also includes reference to the benchmark of 60% of GDP – signatory countries are expected to reduce their levels of government debt by one twentieth of the difference between the actual government debt-to-GDP ratio and 60%. A second reference point for government debt is the 90% of GDP that Reinhart and Rogoff (2009) found to be the threshold at which government debt historically tended to become a drag on growth. At levels of government debt above the (again, admittedly ill-defined) threshold, a lender of last resort for sovereigns better stand ready to avoid default as a result of a market funding strike.[29]

As noted in the case of Spain, we are still likely to see bank debt restructuring, including senior unsecured bank debt restructuring, not just in the periphery but throughout the EA, because some of the worst EA banks are in the core, and because, as pointed out in Buiter (2012), the option of recapitalising banks by bailing in the tax payers rather than the unsecured creditors, even if the sovereign is able and willing to do so, is likely to be much reduced as a result of banking union.

Finally, at a global level, markets and financial institutions are about to drown in another massive wave of liquidity.

Finally, at a global level, markets and financial institutions are about to drown in another massive wave of liquidity. Add to the contingent balance sheet expansion of the Eurosystem through the OMT (and likely through future LTROs and other subsidized collateralised lending operations for banks as well), first, the state-contingent and in principle open-ended QE3 announced by the Fed; second, the time-dependent large scale asset purchases (LSAPs) announced (on a surprisingly large scale) by the Bank of Japan; and third, the prospect of the Bank of England extending its QE beyond the currently authorised £375bn Asset Purchase Facility, when the APF reaches its current limit at the end of October 2012. The result is another wall of advanced country money that will at least in part make its way through the foreign exchange markets towards the EMs, resulting in a range of policy responses there to prevent EM currency appreciation deemed excessive. Among these measures will be EM credit expansion policies also.

In the advanced economies, with the official policy rates at or near the effective lower bound, diminishing returns have set in well and truly to central bank balance sheet expansion through large-scale purchases of the highest available credit quality and liquidity. The Fed's purchases of Treasuries and of Agency MBS and the Bank of England's purchases of gilts fall into the 'minimally effective in stimulating the real economy' category. Because the ECB is still 75 basis points away from zero as regards the refi rate, and because the Eurosystem tends to expand its balance sheet through the outright purchase of less liquid and higher credit risk instruments, and through lending to often near-insolvent banks that offer as collateral instruments issued by or guaranteed by high-risk sovereigns, its enhanced credit support probably offers much greater bang-per-buck than the LSAPs of the Fed and the Bank of England.

[29] See also Buiter and Rahbari (2012b)

Everywhere, since the liquidity trap is not ‘perfect’, some of the liquidity will leak into the most liquid asset markets, including the sovereign debt markets, the foreign exchange markets, equity markets and commodity markets. Impacts on the much less liquid markets for real estate appear to be much smaller. This combination of near-zero or indeed negative interest rates at maturities of up to 2 or 3 years and unlimited liquidity makes markets other than short-term debt markets happy and creates the risk of financial asset booms, bubbles and busts almost anywhere in the world, even with the real economy performing, at best, in a disappointing manner. With official liquidity the main driver of generous asset valuations, the risk of asset market collapse is always with us.

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Appendix A-1

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