Still going down?

In the December 2011 edition of Pulse (and Spring 2012 edition of Big Picture) I argued that the euro-zone was heading for a break-up in 2012 – ‘This sucker is going down’. Slightly tongue in cheek I speculated that the break-up might come in time for some cheap summer holidays in the Club Med economies this year.

Clearly the break-up hasn’t happened yet and so do I still think the euro is going down?

My best response to this question comes in a quote from the economist Rudiger Dornbusch: “In economics things take longer to happen than you think they will, and then they happen faster than you thought they could”.

The main argument of this paper is that the centrifugal forces pulling the euro apart are still stronger than the centripetal forces holding it together. However, the proposed Draghi Plan does provide a temporary way out, if it were to be fully implemented.1 Daily Telegraph economics correspondent Jeremy Warner has written that: “Mr Draghi has at least managed to buy a bit more time. The endgame has been pushed further, possibly quite a lot further, into the future”.2

The IoD has consistently argued that massive bond purchases by the ECB (unlimited open market operations) to drive down bond yields in the peripheral economies, would provide a way out of the crisis. Our consistent position has been that it would work, but it was highly unlikely to happen on the required scale.

What has changed recently is that Super Mario has managed to persuade the ECB board that ‘outright monetary transactions’ are necessary because the ‘convertibility risk’ of the euro is threatened by speculation about a break-up (see below). Using this argument enables him to flank the criticism that bond purchases are merely printing money to finance public debt.

Speculation alone over the potential impact of the Draghi Plan was sufficient to calm financial markets in July and August, after Mario Draghi said the ECB would do “whatever it takes to save the euro”. His ‘bring it on’ manoeuvre towards financial markets showed just how powerful a role the ECB could take, unleashing unlimited firepower to cap yields in the Club Med economies. Super Mario scared off the bond vigilantes. If the threat is enough to calm markets, the obvious thought is what would happen if the ECB began to operate massive bond purchases (though sterilisation of the transactions is not the same as QE) way in excess of its previous Securities Market programme?3

There can be little doubt that massive purchases would drive down yields4. The issue is whether or not the ECB will be allowed to engage in quantitative easing on the required scale. The announcement of potentially unlimited ‘outright

1 The German Constitutional Court has ruled that the ESM and the EU’s Fiscal Compact are compatible with the country’s Basic Law. However the GCC ruling is double-edged, because it effectively blocks Eurobonds and debt pooling and stipulates that any ESM package for Italy or Spain would require a vote in the Bundestag.
2 In order to deal with German concerns about deficit financing by printing money, and the inflationary threat, the outright monetary transactions will focus on the short end of the yield curve (1-3 year maturity) and will also be sterilised (the ECB will take in deposits to counter the expansionary impact of outright monetary transactions on the money supply).
3 The Draghi Plan – to drive down yields.
4 The survival of the euro in its current form depends on massive purchases of peripheral country bonds by the ECB – the Draghi Plan – to drive down yields.
5 Even the Draghi Plan only provides a temporary solution, buying time. The competitive losses in the peripheral economies are so large that external devaluation (currency exit) will probably prove more attractive ultimately than internal devaluation (sharp falls in wages, austerity and massive unemployment).
6 The Draghi Plan is conditional on peripheral economies signing up for further austerity measures and an erosion of fiscal sovereignty. There is no certainty that countries such as Spain will be able to implement such policies, thereby increasing the risk of exit.
7 If the monetary option fails (monetisation of debt) the fiscal option (mutualisation of debt) is even less likely to succeed.
monetary transactions' by the ECB, in the face of Bundebank opposition, is the equivalent of drinking at the last chance saloon for the euro. There is no credible policy alternative left to prevent a peripheral break-up, if outright monetary transactions fail. Speaking about the euro crisis, US economist Paul Krugman has stated that: "Either the Germans have to accept something they consider unacceptable (printing money), or they have to accept something that they consider unacceptable (the break up of the euro)." Krugman’s point is actually quite simple. Either the ECB aggressively buys peripheral debt and caps the borrowing costs of the Club Med economies, or the game is over. This conclusion is the inevitable consequence of crisis hit euro-zone countries having issued debt in a currency they can't print. Let's examine why.

For ease of explanation we’ll examine the 4 potential policy responses1 to the crisis, with the Draghi Plan last of all. The aim of this process is to show that policymakers really are drinking at the last chance saloon without implementation of the Draghi Plan. The 4 key policy options are:

- **Political union** – The rapid formation of a United States of Europe – a unitary state – with a single political entity, single fiscal policy and substantial north-south fiscal transfers, would be the ultimate game changer. But this is obviously not going to happen anytime soon. All too often the answer to EU problems is said to be ‘more Europe’, but change on this scale requires years and decades not weeks and months. The challenges to national sovereignty and resistance to fiscal re-distribution are so great no effective solution is likely from this source.

- **Mutualisation of Debt** – Mutualisation is meant to obscure differences in creditworthiness and covers a range of quasi-fiscal union proposals extending across common euro-zone debt issuance, mutualisation above certain thresholds of debt and rescue facilities such as the EFSF and ESM.

Sovereign political opposition to the fiscal option is intense, especially in northern economies such as Germany and the Netherlands. German political opposition sees the fiscal option as a hand-out to irresponsible Governments, and only to be engaged in if very tough binding fiscal controls are put in place as part of any rescue package. Germany worries about moral hazard – more money has to be dependent on more fiscal control of the peripheral economies, otherwise there will be even more good money chasing after bad in the future. The problem of course is that the loss of sovereignty implied is too high a price for Club Med Governments.

Yes, Germany will agree to a form of fiscal union, providing its concerns about moral hazard are met – with a hard, binding fiscal pact. But unfortunately its concerns about moral hazard are so great the political consequences for countries such as Greece and Spain seem unacceptable.

There are also fundamental challenges to the rescue packages already agreed, with potential contributors to the funds, such as Spain and Italy, also at risk of being bailed out themselves, putting an even greater ‘circumscribed’ fiscal burden on the remaining contributors such as Germany. If that’s not enough to be concerned about, the German Constitutional Court ruling in September also made any rescue package conditional on a vote in the Bundestag.

Underpinning all these debates as well are the ‘old arguments’ between Germany and France. The French want political control over the ECB and the Germans want budgetary discipline.

**Hybrid schemes** – The most significant hybrid scheme is probably the proposal to issue the ESM rescue facility with a banking licence. This would enable it to leverage its capital by borrowing potentially unlimited funds from the ECB – and intervene directly on markets to drive down spreads on periphery debt. The idea is that this could reinforce the carry trade incentives in the ECB’s Long Term Refinancing Operation, to purchase bonds.

However, Germany has all sorts of problems with such an approach, believing it could unleash the beast – potential unlimited commitments with little/no control. An immediate problem is that the ECB is not meant to lend to Governments, whilst the rescue funds are very clearly state institutions. A rescue facility with a banking licence could engage in bond purchases at primary auctions, something anathema to the Germans. To Germany, giving the ESM a banking licence would be a de facto ability to print money. At present the ECB is prevented from buying bonds in primary markets.

**Monetisation of debt** – At the end of July, ECB President Mario Draghi indicated that plans were underway for the ECB to intervene in periphery economy bond markets to drive down yields and put in place yield caps. Merely suggesting this could happen was enough to inject greater stability into financial markets. The new Draghi Plan, announced in September, is the old Securities Market Programme, on an epic scale, with bells and whistles.

The Draghi Plan is a combination of sensible economics (conditionality) and slick public relations (convertibility).

Instead of trying to make the case for ‘printing money’ – always a difficult sell to the Germans – Draghi has let the emphasis fall on the issue of ‘convertibility risk’. In other words the existential systemic threat to the euro warrants aggressive bond purchases to maintain convertibility, because the

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<thead>
<tr>
<th>Table 1 – Decision time</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 8th</td>
</tr>
<tr>
<td>October 10th and 11th</td>
</tr>
<tr>
<td>October 11th and 12th</td>
</tr>
</tbody>
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1 Thoroughly there is an additional policy option to avoid the peripheral economies departing the euro, namely that the core economies such as Germany depart the euro instead – leading to a sharp appreciation in the replacement currency. This would also avoid countries such as Greece facing higher debt servicing costs – demotivated in euros – due to the depreciation of any new currency against the euro. However, we believe such a scenario is highly unlikely because it would require Germany to be the country which killed the euro – a fundamental geo-political shift on this scale owners impossible.

2 Primary bond markets refer to Government debt auctions. Secondary markets trade bonds sold at primary auctions.

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functionality of the currency is under threat with a potential break-up.

In the face of Bundesbank opposition, the ECB has effectively agreed to the monetisation of debt – printing money to buy bonds in the secondary market – whilst dressing the policy in the clothes of convertibility risk.

But don’t think the Bundesbank or German public opinion can be ignored. The old issue of moral hazard comes to the fore again. If you buy bonds to drive down yields, what incentive is there for the debtor nation to impose fiscal austerity measures?

The Draghi Plan attempts to overcome this problem with conditionality. The ECB will only engage in secondary market purchases after the country has requested the ESM for a bailout – which could also act as the trigger for the rescue fund to purchase debt in primary auctions. Conditionality requires that in return for a bailout strictly enforceable conditions are applied.

Whether or not the Draghi Plan is likely to be fully implemented is a very moot point. Germany is giving out very mixed signals to it.

Finance Minister Wolfgang Schäuble has said that monetary financing of state deficits is an anathema: “If we start that we won’t stop”. Bundesbank President Jens Weidman has warned that ECB bond purchases, even in the secondary market, “could become addictive like a drug”. Press reports suggest that Weidman threatened to resign over the issue, before backing off.

In contrast, Chancellor Merkel and the other German member of the ECB Board, Joerg Asmussen, are sending out more positive signals. Discussing the issue of convertibility, Asmussen has stated that, “a currency can only be stable if its future existence is not in doubt”.

And so the battle lines are drawn. On the one hand are the traditionalists who argue that the very concept of an independent central bank is under challenge, with the risk that it could lose control of the money supply. The Draghi Plan is almost certainly a violation of the letter and spirit of the no bail out clause in the Maastricht Treaty, with only the lame excuse that the ECB would be buying debt in the secondary as opposed to the primary market.

Moreover, in the wake of the announcement of “outright monetary transactions”, the German Constitutional Court has stated: “An acquisition of government bonds on the secondary market by the ECB, aiming at financing the member budgets independently of the capital markets is prohibited as it would circumvent the prohibition of monetary financing”.

Traditionalists also point to the potential exposure of taxpayers if the bail-out operations go wrong and the Bundesbank and ECB need recapitalising. The bottom line here is the systemic hole at the heart of the euro project – countries don’t control the currency in which they issue their debt and as a result there is a liquidity-insolvency negative feedback loop which could require massive quantitative easing to overcome, if financial markets decide a country is bankrupt.

On the other hand are the progressives who argue the very existence of the currency is under threat, and the downside risks are so immense, that exceptional circumstances call for exceptional measures and that the Draghi Plan is not that radical when the importance and role of conditionality is recognised.

But conditionality also raises its own issues. Who blinks first? The ECB conditionality shows that even with German agreement to the Draghi Plan (and that of other countries with issues, such as the Netherlands and Finland), it can only be implemented and triggered by a debtor country application for a bail-out, subject to very strict conditions. Could Greece or Spain sign a ‘fiscal memorandum’ effectively giving up fiscal sovereignty? Could they sell even more austerity to their electorates? I doubt it. Could Chancellor Merkel sell weak conditionality and printing money to the German electorate? I doubt that also.

The practical issues are immense as well. Who decides which bonds the ECB buys? Who decides the level at which yields are to be capped? The ECB is not answerable to any Parliament, but it would be acquiring a quasi-fiscal role.

WHERE DO WE GO FROM HERE?

It is difficult to believe that the status quo can hold. Greece is behind with its austerity plan, Club Med money supply is contracting, headline unemployment rates are touching 25% in Greece and Spain, structural reforms can’t generate the growth to offset the austerity measures and there is a yawning gap between the interest rate on debt and GDP performance – requiring a sustained fiscal primary surplus (the fiscal balance before interest payments). Something has to give.

The Draghi Plan, fully implemented,
could be the game-changer which has been lacking over the past 2 years. We shouldn't underestimate its potential firepower. However, the scale of its potential impact is part of the reason the Bundesbank opposes it - because it is a fundamental challenge to the status of an independent central bank.

Even if the Draghi Plan is fully implemented it won't provide a permanent solution to the euro crisis, but it will buy time. In the long term the competitive losses in the Club Med economies make it very difficult to believe that all the adjustment will stem from an internal devaluation - falling wages, austerity and rising unemployment.

What happens if a country such as Greece or Spain backslides on its austerity plan? Does the ECB stop bond purchases? If it stopped purchases the bond market would implode. If it carried on such purchases, German public opinion would explode.

As this edition of Pulse goes to press at the end of September, there are riots in Greece and Spain, with police firing rubber bullets, further undermining investor confidence.

Without full implementation of the Draghi Plan the odds favour short-term exits from the euro. Even with full implementation of the plan there will almost certainly be long-term exits from the euro.