The “White Knight” Makes His Move

Though the European Central Bank says it will defend euro using all available means, the monetary union still badly needs concrete policy decisions by European governments. by *Giuseppe Scognamiglio*

The German Constitutional Court’s recent ruling that the European Stability Mechanism (ESM) and the fiscal pact don’t violate that country’s constitution are good news for Europe. The ESM mechanisms will allow for the purchase of bonds issued by crisis-stricken nations on both primary and secondary markets within the euro zone.

The German move, along with the European Central Bank’s early September announcement that it would intervene “without limits” to purchase the state bonds of countries facing speculative pressure on secondary markets (so-called Outright Monetary Transactions) — subject to the recipient nation’s compliance with strict constraints — has finally generated a system of credible tools in defense of the euro.

The events came in the wake of considerable summer pressure that had called on the ECB’s so-called “White Knight,” namely its chief, Mario Draghi, to enter the fray in a demonstrable way. He complied.

But at this juncture it’s vital to assess just what the ECB can and can’t do.

The ECB, as noted, is the euro’s central bank. Its main task is to preserve the currency’s purchase power and ensure price stability within the euro zone, which includes the 17 European Union states that adopted the currency in 1999 and employed it soon thereafter. The economic and monetary union hinges on the four central criteria:

1. Price stability;
2. Exchange stability;
3. Interest rate convergence;
4. Budgetary discipline.

The ECB has been extremely effective in achieving the first two objectives (price and exchange rate stability), which are the classic primary objectives of monetary policy. Inflation control within the euro area enabled interest rates convergence among the member countries, the third objective, for almost a decade — until the beginning of the sovereign debt crisis. The fourth demand, fiscal discipline, seems out of reach in the absence of a European treasury. The decision to avoid such monetary centralization encouraged a number of peripheral countries to take advantage of low interest rates and increase public spending and borrowing.

But financial crisis induced a number of countries (Ireland, Spain, and the UK, which is outside the euro) to use public money to rescue the financial system, further aggravating the public debt so-called in the so-called PIIGS states (the pejorative acronym informally assigned to Portugal, Ireland, Italy, Greece and Spain).

Quantitative limits on national spending imposed by Stability and Growth Pact of 1997 (maximum deficit-to-GDP ratio of three percent and a debt-to-GDP ration of 60 percent), established strengthen the Maastricht Treaty, failed to create fiscal policy convergence, in part because there was no effective system of sanctions to punish violators.

Ongoing market mistrust is primarily due to doubts about the sustainability of the single currency in the face of systemic crises such as the one Europe is now experiencing. The heart of monetary union weakness as seen by markets is the absence of fiscal integration, which would freely allow for the transfer of national resources from surplus to debtor states. Moreover, the absence of a EU-wide framework that allows for the effective management and resolution of crises among cross-border banking groups has fueled both the financial crisis and the sovereign debt crisis, creating a vicious circle.

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European Central Bank President Mario Draghi.

The recent ECB proposals are intended to break this circle.

Draghi and the ECB’s Governing Council forcible reiterated the bank would use any means necessary within its mandate to preserve the monetary union. This means the ECB will attempt to address the crisis and ensure monetary stability by continuing to use so-called “unconventional weapons,” both in its role as a lender of last resort for the banking sector and as a buyer of government bonds of peripheral states on secondary market (already being done, though more cautiously and in limited quantities).

The varying interest rates within the monetary union undermine monetary transmission mechanisms, even in an effort to stabilize prices. In that sense, the purchase of peripheral state bonds on secondary markets doesn’t seem to conflict with the ECB’s mandate, since its main objective isn’t to finance national deficits but to maintain stable prices. Obviously, this can have a potentially positive effect on interest rates paid by so-called PIIGS public debt (i.e. on the deficit).

The ECB’s action was an essential short-term move to deal with speculation within markets that clearly have their doubts about the fundamental sanctity of the euro zone as well as the status of some its peripheral nations, such as Italy (where government reform and spending curbs have not yet proved convincing).

But seen more broadly, the ECB’s recent moves seem to be an exercise in buying time. Such moves, however well-intentioned, simply can’t replace political action aimed specifically at a redrawing of Europe’s economic and monetary architecture in a way that might sustain the whole over the long haul. Clearly, the medium-term goal is the establishment of a Europe that’s both more politically cohesive and more effective in terms of tax structure, a kind of “Federation Lite,” as I wrote in the previous issue of this magazine.

As mentioned earlier, the long-awaited German Constitutional Court verdict means the ESM can finally begin functioning. It will have €500 billion in funding to support governments unable place its debt on the market (both primary and secondary) and troubled banking groups. Obviously, giving effective support to deeply indebted countries would mean increasing the amount of funding the ESM has at its disposal.

The current German position that opposes giving the ESM banking licenses that would allow it to increase its available resources by using leveraged financing (the possibility of bidding for loans from financial institutions against their €500 billion in assets) seems anachronistic at best.

In fact, Germany's behavior seems occasionally euro-hostile, which is a paradoxical position given that Germany ranks among the biggest beneficiaries of the single currency over the last decade. It has a trade surplus with other euro countries (helped out by the inability of PIIGS nations to issue write-downs) and with most of its global trading partners, an export-driven advantage that was fundamentally facilitated by the weaker euro (compared to the Deutschemark).

Even today, a potential German exit from the euro, an option many Germans say they want to pursue, would only penalize the same people who seek it. A recent Bank of America-Merrill Lynch study (the latest in a series on the subject by various think-tanks) suggests that Germany's voluntary exit from the euro zone would penalize it far more than other countries tied to the single currency. The study ranks 11 euro zone countries (Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Greece, Portugal, Ireland and Finland) on the basis of the impact of a voluntary exit would have on each of them, based on the impact on national growth, financial position, and net international borrowing costs.

Though Germany would have the best chance of making an "orderly exit" from the euro, compared to other countries it would record the greatest negative impact in all the categories covered by the study. In relative terms, Italy and Ireland were seen as potentially suffering the least, cost-wise, if they left the euro zone voluntarily.

Here's what the BoA-Merrill Lynch study emerged with after studying the euro status of Italy and Germany.

1. If Germany left the euro, its exports would likely suffer as a result of the relative appreciation of the "new" Deutschemark. The predicted decline in exports would cause a production drop equal to seven percent of GDP.
2. With a production system 50 percent tied to the European market, the exchange rate would level out in a way that eliminates the differential between the cost of labor per unit, reducing its competitive advantage (since 2000, unit labor cost in Germany have increased by six percent compared to an average of 20 percent recorded in the whole of the euro zone).
3. A euro exit would also increase the German public debt. Once out of the euro, Germany bonds would lose the appeal as a risk hedge, something that has already been verified as the euro crisis deepened. The increase in real bond income is estimated at 80 basis points, assuming the existing debt is converted into the new currency.

Finally, Germany's exit from the euro, and the appreciation of the new Deutschemark against the "new" euro in a union without Germany, would result in a decrease in the value of net foreign assets held by residents, which would be calculated based on new euro values. This phenomenon would be hugely significant for a new euro creditor country, which Germany would immediately become. Its net external position in terms of GDP would decline by an estimated 31 percent.

These same effects would be mirrored, but in a more positive way, if Italy left the euro voluntarily. It would register GDP growth of three percent (its exports would become more competitive) and a decrease in real government bond yield of an estimated 20 basis points (due to a rise in inflation). It would also profit from an improvement in its net position toward "new" euro states equal to 15 percent of GDP.

Naturally, these results are worth little more than a grain of salt. They are simulations are based on linear assumptions. They assumed likely but uncertain hypotheses, foremost among them that the existing stock of debt is redenominated in terms of new currency, the Lira for Italy and the Deutschemark for Germany.

Ultimately, Europe's real "White Knight" may not be Draghi, who can do little more than set a true course in stormy seas. To help with the crossing, Europe needs political decisions of historic import. Germany must understand once and for all that it faces a unique opportunity to take the moral and political leadership of the future United States of Europe.

AMERICAN SNAPSHOT

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