The European Institute

[The Euro Crisis Update – "Thank you, Greece, for Saving the euro!"]

January 2, 2013

*By J. Paul Horne, Independent International Market Economist **

Mired in depression and record unemployment, Greeks may not greet the New Year with joy. But the euro-zone, the E.U. and even the world, owe Greece a big "Thank You" for triggering major institutional, structural and financial changes that are saving the euro and making Europe more competitive.

Ironically, confirmation that the euro-zone has survived comes from the very financial markets which triggered the "euro crisis" in November 2009, when peripheral European governments' bond yields began to soar far above Germany's benchmark government bund yield. When the crisis reached its nadir in spring 2012, the Greek yield spread had soared to 35%, meaning Greece could not borrow on international markets.

This inspired market experts (many of them perennial euro-skeptics) to forecast a "GRexit" - Greece being forced out of the Euro zone, the first step toward the collapse of Europe's single currency. But these Cassandras grossly under-estimated the institutional changes that the crisis has forced on euro-zone governments and especially the ECB (European Central Bank). We think further, positive, changes will come in response to continuing market pressures in 2013.

Once the international bond vigilantes woke up to Greece's egregious fiscal situation and began to punish "peripheral Europe", once referred to as the PIIGS (Portugal, Ireland, Italy, Greece and Spain), a fundamental struggle ensued between the ECB and politicians. The ECB was much criticized for being reluctant to use its vast monetary powers aggressively after the 2007-2009 financial crisis.

Deliberate Inertia

In fact, the ECB's strategy of deliberate inertia was calculated to boost pressure on euro government politicians to take corrective budgetary action, which they might not have if they thought the ECB could/would deal with the debt crisis by itself. (This may prove to be a crucial mistake by the Fed, since it has used extraordinary monetary policy since 2008 to assure financial stability and economic growth, arguably contributing to Congressional inaction that has allowed the fiscal situation to deteriorate.)

Soaring bond yield spreads aggravated the recessionary effects of austerity programs, threatening the euro-zone with a downward debt spiral. Faced with riotous public protests and intransigent bond markets, politicians caved in and began to act to correct the institutional short-comings of the single currency area.

As EU governments approved the institutional reforms, described below, the ECB then leaped in dramatically with rapidly escalating market pressures. In December 2011 and February 2012, the central bank did its first Long-Term Refinancing Operations (LTRO), lending, at very low cost, EUR 1 trillion to some 800 Euro banks, making clear there could be more.

The LTRO calmed fears about bank liquidity, but the banks used the cheap LTRO funds to buy higher-yielding government debt, thus boosting the banks' exposure to increasingly doubtful government debt just as the EU economy was decelerating into recession, worsening government deficits and debt servicing.

This potentially fatal nexus of a euro-banking system's growing dependence on increasingly worthless government debt securities, plunged markets into a tailspin in spring 2012. This helped persuade euro leaders to agree in March a "fiscal compact" for tighter political control of Euro countries' budget policies. **This is potentially a major breakthrough toward coordination of more prudent fiscal policies in the euro-zone – in effect, a fiscal union, the lack of which has been the fundamental flaw of the single currency.**

Whatever It Takes

With the fiscal compact approved but skeptical markets keeping the pressure on, ECB President Mario Draghi (who succeeded Jean-Claude Trichet in November 2011), announced a long-awaited and all-important guarantee. In late July 2012, he stated that the ECB would "do whatever it takes to preserve the euro." The ECB thus committed itself to use its theoretically unlimited resources to prevent the bankruptcy of a euro-zone country and, potentially, the euro's collapse.

Specifically, Draghi's guarantee meant that the ECB would buy, on the secondary market--its charter forbids it from buying debt securities directly from the issuing government--unlimited amounts of debt instruments of a euro country in crisis. But only if and when that country requested assistance from the European Stability Mechanism (another of the E.U.'s major new institutions born of the crisis) and accepted the ESM's conditions. On Sept. 6, 2012, the ECB announced its new Outright Monetary Transactions (OMT) program to buy unlimited amounts of government debt instruments of any euro-zone country submitting to the ESM.

Further responding to the bank-government debt crisis, the 27 EU heads of government took additional dramatic action, giving final approval in December 2012, to a new banking union with a single supervisor: the ECB. The Single Supervisory Mechanism (SSM) will oversee bank and non-bank lenders in the euro-zone under control of the ECB. The SSM will monitor TBTF (too big to fail) banks' lending and trading as well as risk exposure. It will also supervise bank defaults. If fully implemented by 2014, the SSM could be a significant step toward financial integration.

The SSM/ECB will directly supervise up to 200 of the largest euro banks by March 2014, requiring that national governments give up considerable control over their most important and TBTF banks – a politically sensitive loss of national and financial sovereignty. The SSM will have primary responsibility as the euro bank supervisor, cooperating with the London-based European Banking Authority (see below), which establishes technical and operating standards for all 27 EU states in cooperation with national supervisors. Banks with assets of over EUR 30 billion euros, or equal to 20% of a state's economic output, will report to the SSM. The single supervisor will also allow banks to be re-capitalized directly on the market or by the ECB, rather than with more government debt.

Toward Banking Union

Draghi told the European Parliament on Dec. 17, that the SSM is only the first step towards a banking union, noting that there must be a banking resolution mechanism, as well as a European deposit insurance scheme." SSM banking supervision will be, he added, "rigorously separated" from ECB monetary policy decisions, with "a completely separate body" making its supervisory decisions.

The *Financial Times* editorialized that the SSM is the "first step towards a euro-zone banking union designed to shore up confidence, resuscitate cross-border bank lending and bring down painfully high borrowing costs for banks in peripheral euro-zone countries." But the *FT* noted that London banks are likely to have an ambiguous relationship with the SSM. Christian Noyer, Bank of France governor, emphasized last autumn that it would be incongruous if the SSM's regulatory authority did not extend to large banks in The City, which do much of their business in the euro-zone.

In addition to the ECB's vastly expanded role and the new SSM and banking union, we would note the following significant institutional achievements by euro-zone government leaders as a direct result of the euro crisis. As we have reported for The European Institute in the past, these include:

+ The European Stability Mechanism (ESM) was established on Sept. 27, 2012 in Luxembourg as a permanent rescue program for euro-zone countries with a debt or payments crisis. It has AAA-rated borrowing-lending authority of an initial EUR 500 billion ($650 billion). (The ESM succeeded the temporary European Financial Stability Facility (EFSF) and European Financial Stabilization Mechanism (EFSM).)

+ The Fiscal Stability Treaty (the "fiscal compact"), formally known as the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, was agreed on March 2, 2012 by 25 of the 27 EU countries (the UK and Czech Republic opted out). It goes into effect on Jan. 1, 2013, in each euro country that has ratified it and aims at prudent and coordinated budget policy-making by euro governments, with a vetting role for the European Commission.

+The European Systemic Risk Board (ESRB) was created on Dec. 16, 2010 as part of the European System of Financial Supervision (ESFS) with responsibility for the entire 27-country EU. The ESFS includes: the European Banking Authority (EBA) for supervising the EU's principal banks; the European Insurance and Occupational Pensions Authority (EIOPA) to regulate insurance and pensions; the European Securities and Markets Authority (ESMA) for financial markets; and a Joint Committee of the above European Supervisory Authorities (ESAs) which coordinates with national supervisory authorities.

While euro-zone and EU leaders, pushed by inexorable market forces, were struggling to reach agreement on these momentous institutional changes, in Greece, seriously angry voters tightened their belts, voted to stay in the euro-zone, elected a coalition government committed to fiscal reform, negotiated a debt buy-back with a "haircut" for investors, and persuaded the "Troika" (the European Central Bank, the European Commission and the IMF) to extend its austerity deadlines. The Troika then rewarded Athens with the second installment on its bailout package, and the ECB made Greek bonds again eligible to be collateral for ECB lending, delighting the markets.

Markets Approve

The euro-zone's other "debt-beats" also benefited from these institutional changes as well as painful austerity programs. Spain's yield spread dropped from 5.8% to 3.9% by end-2012; Italy's from 4.9% to 3.2%; and Portuguese bonds made investors almost 80% (in dollar terms) between February and December 2012 as their spread over the bund plunged from 17% to 7%.

Even the Euro STOXX 50 index of blue-chip equities, down 17% in 2011 and another 10% by May of last year, finished 2012 up 13%, better than the 11% rise of the U.S. S&P 500.

The euro, which many experts pronounced moribund last spring, has averaged (using daily Fed FX data) $1.34 since November 2009; $1.29 in 2012, and $1.21 since it was born, on Jan. 1, 1999. The USD:EUR rate never dropped below $1.19 since November 2009, proof that FX traders (in the world's largest financial market), did not consider the euro to be moribund.

The euro survives, as we expected (see: “In the Long run, Will Europe be Grateful to Greece?" in “European Affairs”) for the simple reason that dissolution of the single currency would have triggered massive financial disruption around the world and risk triggering a global economic depression.

This analysis remains correct. There is no alternative to measured belt-tightening and structural reforms of the sort made to date, no matter how irritatingly slow and reluctant the 17 euro-zone governments may act. On the bright side, it is now clear that the European Central Bank will act promptly and massively when circumstances warrant.

Political Change

Political change has also been encouraging with Italy implementing needed reforms under the principled and technocratic guidance of out-going Prime Minister Mario Monti. The same is true for Spain, despite its 25% unemployment rate. Portugal and Ireland have continued their battle to reduce their deficits and debt, despite widespread street protests. Noteworthy is that **nine Euro governments have been changed** since the debt crisis began in November 2009. This includes Mario Monti’s government since he resigned on Dec. 21, 2012 – a remarkable political transformation that ultimately re-enforces the commitment to the euro.

We hope politics will continue in the right direction signalled by Mario Monti being elected in February to continue reforming Italian institutions and competitiveness; with Angela Merkel re-elected next September with a viable government coalition; and with French President Francois Hollande re-considering some of his more populist policies. We also hope that Tory Prime Minister David Cameron will not cave into to his euro-skeptics’ pressure for a risky referendum on U.K. membership in the EU.

The euro-zone will, we continue to believe, muddle forward this year, 2013, toward yet more useful institutional changes leading toward fiscal union. What is certain is that market pressures will keep the heat on euro politicians to keep moving toward greater fiscal, monetary and economic union. Greece can confirm that.

J. Paul Horne is an Independent International Market Economist based in Alexandria, VA and Paris where he was chief international economist for Smith Barney for 24 years. He retired as a Managing Director of Salomon Smith Barney/Citigroup in 2001 but remains active with the National Association for Business Economics, the Global Interdependence Center and the Société d’Economie Politique in Paris.

The European Institute is a leading Washington-based public-policy organization devoted to transatlantic affairs. It provides an independent forum for U.S. and European government and corporate decision makers, officials from multilateral organizations, foreign and economic policy analysts, and expert journalists to exchange information, develop innovative policy options, and creates new professional working relationships.

This article was published in the Institute’s journal, “European Affairs”, which can also be seen at: http://european.institute.org/.