BULLETIN

EUROPEAN CENTRE FOR INTERNATIONAL POLITICAL ECONOMY
ECIPE

ECIPE Bulletin No. 07/2012

The Meaning of the Unsaid: The New Eurozone Deal in Perspective

By Fredrik Erixon (fredrik.erixon@ecipe.org), a Director and co-founder of ECIPE

Expectations were low as European leaders gathered in Brussels on Thursday last week for yet another summit to deal with an escalation of the crisis. But on Friday morning markets rushed on the news that Angela Merkel, the German Chancellor, had climbed down from previous positions and agreed to sweeping changes in Eurozone crisis policy to help Spain and Italy. Even the connoisseurs of Eurozone crisis politics were taken by surprise. So, was this summit the much-wanted turning point in the crisis, with leaders finally doing the right thing after having exhausted all the alternatives? No.

There are four important takeaways from the summit. Two of them offer some optimism about the future. The other two suggest it will become more difficult than before to get to the point when markets no longer have to price in sovereign default or euro breakup risks in their judgements about fiscal, financial and economic adjustments.

So what are the notes of optimism? First, the fact that compromises were made, and that the leading power in the Eurozone backed away from a previous position, demonstrated that the Eurozone is not ungovernable. Some will argue the opposite. Idealists will say that we already knew that the euro is manageable and that EMU members are willing to do whatever it takes to save the euro. Cynics, on the other hand, will argue that it is only when other countries are blackmailing Germany that things can get done. They are both wrong. Support for keeping the euro project together is not infinite and fractured Eurozone leadership has been at the heart of the Eurozone crisis for a year now. Attempts to gloss over the profound differences in views on crisis policy between governments only weaken confidence in the euro. But leaders proved at the summit that there is *some* preparedness to change a policy that is leading nowhere, or in the wrong direction.

Second, the general agreement that leaders made on using the European Stability Mechanism for direct capital injections in banks may prove crucial for Spain – and the Eurozone. Deepening the intimate relation between fragile banks and a fragile sovereign – which would be the effect if financial assistance to banks is routed through the Spanish government – would inevitably push Spain towards a sovereign default, forcing another (and much bigger) bailout package to the country. There is still a downside risk that the Spanish government, too, will need a bailout. But a separation between the balance sheets of banks and sovereigns is crucial for current Eurozone crisis policy to work.

Let us now turn to the two more troubling aspects of last week's Eurozone deal. None of them were directly addressed during the summit; at least they are not mentioned as such in the communiqué. They are rather likely consequences of choices now made by Eurozone leaders. And they both relate to the Eurozone's Jerry Maguire problem: show me the money!

To have calming effects on markets, the firepower of any bailout mechanism would have to be in excess of 2 trillion euros. Together, the EFSF and the ESM have the capacity to lend another 500 billion euro. As the Eurozone has committed itself to assist the Spanish banking sector with 100 billion euro, only 400 billion euro remains. And it is highly likely that Ireland and Portugal will need new assistance beyond their current programmes. Assuming an overall supportive economic environment, they will not need as much as they received in their first packages. But it is not to stretch the imagination too far to suggest another 100 billion euro in the Eurozone's bailout capacity will have to be committed to Portugal and Ireland. Furthermore, Cyprus has requested support and will need assistance in the 5-10 billion euro region. And, finally, Greece will need further assistance, especially if the resistance to another restructuring of Greek debt remains.

To sum this up, it is likely that at least 250 of the existing 500 billion euros will have to cover existing or additional commitments to assisted countries. Yet 250 billion euros will not take the Eurozone far if it should purchase Spanish and Italian bonds. Together they will have to borrow a little more than 600 billion euro from now up to the end of 2014 (the borrowing need is actually bigger if short-term bills also are included). But where would that money come from?

There are two external sources of money that may be made available for Eurozone support. As far as it is possible to tell, the summit agreement will now make it more difficult for both of them to directly assist Eurozone governments. First, the change in how conditionality will be organised, and the "flexible" use of the ESM, is not compatible with the IMF's approach to neither conditionality nor lending. What Eurozone leaders agreed last week is not necessarily a weakening of conditions that will be attached to new loans. In fact, the communiqué suggests that the flexible use of the ESM – which is code for direct support to banks and direct intervention on bond markets – will be conditioned on countries actually complying with the commitments they have made under the European Semester or the Stability and Growth Pact. That is a tall order for any country that is not capable of paying the bills. They tend to seek external support because their fiscal and economic performances have violated agreed rules over a long period of time. However, the main point here is that bond purchasing, direct capital injections in banks, and conditions "only" sealed in a Memorandum of Understanding are not part of how the IMF does business. Consequently, any future support from the IMF would have to be separated from Eurozone support.

Second, if the ESM purchases bonds, but starts to run out of money, it will become even more challenging for the ECB to step in as a lender of last resort to sovereigns. Given the ECB's mandate in the European Treaty, a big operation on bond markets would require an imaginative justification. The ECB has already shown that it employs people with such intellectual faculties, but designing the defence of a big operation when the ESM has failed to calm markets by its own bond-market interventions is in a different league. It would almost require the talent of a J.R.R. Tolkien or J.K. Rowling.

The summit fudged on the critical issue of resources. And the price that Eurozone leaders have to pay for the changes it made to its crisis policy may be limited financing options in the near future. If so, the meaning of the unsaid announcements in the summit communiqué is that Eurozone leaders waved goodbye to the IMF and the ECB as direct supporters of Eurozone crisis packages or Eurozone governments. However, it does not mean that the ECB is out of the picture, but that its role will be to offer good refinancing conditions to an ESM with a bank license.