A Stress Test for the Euro?

Nicolas Véron says that multiple weaknesses in Europe make it likely that currency markets will keep betting against the euro even if Greece stabilizes.

Edited transcript, recorded March 3, 2010.

Steve Weisman: The euro has continued to sink in international markets, partly as a result of the crisis in Greece. This is Steve Weisman at the Peterson Institute for International Economics, welcoming again Nicolas Véron, our visiting fellow here at the institute and also senior fellow at Bruegel in Brussels. Thanks, Nicolas.

Nicolas Véron: Thanks to you.

Steve Weisman: Okay. So, the euro has been sliding down in value. For what reasons?

Nicolas Véron: It's always difficult to interpret the foreign exchange markets. But clearly the markets are hinting at the inconsistencies in the euro area policy framework and they are basically stress testing the euro area, and at this point the main point of stress is Greece. It may be the case that at some point in the not-so-distant future, if some patch is applied on Greece, it will shift to another country.

Steve Weisman: The news reports suggest that there may be some progress in giving Greece some breathing room. But your view is that, if that situation stabilizes, there are others that the markets will bet against.

Nicolas Véron: Oh of course. A lot is happening at this point behind the scenes and we'll know when a decision is made, which I suspect is not yet the case. So it's only a scenario at this point. But yes there is a scenario that some package can be agreed, perhaps with the intervention of state-owned banks in countries like France and Germany—this had been largely relayed by the press—so that Greece would have some breathing space, would regain some confidence from the marketplace and the dust would settle down on the Greek situation.

Steve Weisman: But there are other ailing countries.

Nicolas Véron: Exactly. We're far from fiscal balance or even fiscal sustainability in many countries of the Euro area, and there are obvious situations, such as Spain, such as Portugal. But maybe also, why not Italy or France that at some point could be tested by the marketplace? At this point, it's still a fast-moving situation. There are many things that we don't know about the state of the banking system in many of these countries. This is still a lingering legacy of the previous phase of the crisis, which hasn't been properly solved in Continental Europe.

So there are plenty of crisis scenarios and I think what the markets are focusing on right now is really the policy framework as such. What do the euro area countries do when there is a problem in one weak link? And I suspect they will be looking for a weak link for some time from now, even if it ceases to be Greece as such. Last year, the weak link was widely seen to be Ireland. Ireland made some tough decisions and basically deflected the attention from their own case, but we could see other shifts in the next few weeks or months.

Steve Weisman: You've advocated more transparency and more of an effort by the banks in Europe to come clean. If the markets don't deliver a stress test to the banks, banks maybe ought to try and get ahead of the markets and do their own stress test.

Nicolas Véron: The US federal authorities have conducted stress tests a bit less than a year ago. This had very positive market effects, even with all the weaknesses that can be found in the exemptions that were applied. There hasn't been anything really equivalent in Europe because lots of European banks are actually, at this point, protected by their home countries, which don't really want full transparency to be applied on their national banking systems.

The paradox of the European situation is that the banking system has become very interdependent on a cross-border basis. There is a lot of cross-border competition, especially when it comes to possible consolidation and M&A [mergers and acquisitions] in the banking sector. So, it seems to me that this banking fragility will not be resolved on a country-by-country basis. You need the coordination at least at the supranational and perhaps EU level for this transparency to be brought, or stress tests, if you want to call them that, or triage processes to be conducted. And this is not happening now.

Also, market discipline is weak because many of the banks, and especially the most affected ones, are nonlisted banks, so they actually deliver fairly low levels of financial transparency. This is the case most obviously of the Landesbank system in Germany and the Cajas, the savings banks in Spain, but also of other parts of the overall system.

Steve Weisman: Do you think this crisis will eventually wake up the European authorities to doing something like a widespread stress test?

Nicolas Véron: I think it would be the right thing to do but there are many obstacles to that and we shouldn't underestimate them. At this point, Europe doesn't even have the authorities to do that. There is no equivalent of the role that the Federal Reserve played in last year's stress test in the United States. The Federal Reserve has widespread supervisory powers; the European Central Bank has absolutely none. And it's actually guaranteed by the Treaty of Maastricht that, absent a unanimous decision of member states, it will get no supervisory powers.

So it's unclear who would do that and again, even more fundamentally, there are at this point several member states [that] really don't want this sort of process to happen. So we do have a weakness here, which I think is profoundly related to what we're seeing in the sovereign area even though it's not exactly the same dynamics.

But we cannot overestimate the linkages between the banking system and what's happening in the sovereign debt crisis, especially when you look at the political dynamics. A lot of what's happening right now is linked to Western European banks' exposure to Greek risks. In a way, that's a positive factor in terms of policy intervention.

It is an incentive for France and Germany to do something about the Greek situation. But we also don't know at this point, what all these linkages are.

Steve Weisman: You mentioned the phrase "stress test" for what the markets are in effect delivering to the euro and by extension, the banking system. But another perhaps less polite [way] of saying it is that speculators are making bets against the euro, especially hedge funds. Is there any reaction to that aspect of this crisis in Europe, a reaction politically?

Nicolas Véron: Yes. There's a lot of political rhetoric at this point that speculators—of course Anglo-Saxon speculators—are betting against the euro to destroy the euro area solidarity and the political influence that can come from there. A lot of this discourse is nonsense and it's a big distraction from the more fundamental policy issues. But it's also, I think, an indication that at the more fundamental level, market and especially financial market mechanisms remain very superficially accepted in large parts of the European Union and this is consistently evidenced by polling data.

So, we do have significant differences of visions of what the financial system should be about in the European Union, which I think is a significant obstacle to cooperation and joint action in this area. That may be one reason why speculation—if you want to call it that—against the euro is so active, that these political differences will hinder joint action in the foreseeable future. It's really an open question at this point, whether the European policymakers can provide a consistent and compelling answer to the pressure from the marketplace.

Steve Weisman: Nicolas Véron, thank you very much.

Nicolas Véron: Thank you.