



New Regimes, Old Problems, in Italy and Greece

Nicolas Véron says that despite the changes in Athens and Rome, Europe has much more to do to address its underlying weaknesses.

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Steve Weisman: After more turbulence in Europe, new governments in Greece and Italy are on the way. Nicolas Véron, visiting fellow at the Peterson Institute for International Economics, where do things stand as of Friday 11/11/11?

Nicolas Véron: Clearly things remain as volatile as ever, and probably what we can say now will become quickly obsolete. But at this point, we just saw enormous volatility in government bond markets, and probably a change of status of Italian debt. The increased margin requirements by clearing houses, and perhaps even more importantly, the perception by a number of global investors that Italy now was in the middle of the storm, means that there are entire categories of institutional investors that are no longer buying Italian debt and will probably not return to it any time soon. So this creates a very serious funding problem for Italy, and experience suggests that some of this may be irreversible, at least for the foreseeable future.

Steve Weisman: Why should it be irreversible, if Italy now has a new government, and is on its way to adopting the reforms that are being demanded of it?

Nicolas Véron: Yes, but you know, the dynamics of supply and demand among bond investors are driven not only by rational analysis of the bonds. They have benchmarks and indexes that are partly dependent on ratings. More and more large investors create their own benchmarks, and a number of them this week or last week have decided that Italy was no longer a part of it, or that its weight had to be lowered. So if you make that decision, you make it for some time.

Steve Weisman: The opposite question is, what took them so long to decide this?

Nicolas Véron: The fiscal fundamentals of Italy are not that bad. It's a wealthy country, there's a lot of money in the country that can be perhaps taxed someday, if it's not evaded. There is a healthy situation in terms of fiscal deficits; there has been a primary surplus, unlike most other countries in the euro area. There is a lively export industry. There are a lot of things that you don't have to the same extent in Greece, and that actually you don't have to the same extent in many other euro area countries. So, Italy is not a basket case; it has a number of economic strengths. But there has also been this failure at reform, this enormous set of rigidities in society and the economy, and it's not clear for investors that even the very competent new government that would be different from the previous government could solve that.

Steve Weisman: What are the chances that the reforms now being thrust on Greece and Italy can actually change the political economic culture in these countries?

Nicolas Véron: I think we have short-term and long-term dynamics here. On the long-term, I'll come back to your question in a moment. But I think we have to keep in mind that in the short-term we have a very destructive dynamic of contagion that has spread to more and more countries in the euro area and, if you include France, has engulfed a very significant part, perhaps a majority of the euro area's economy. And I think one other piece of news this week is the fact that it becomes more difficult to deny that contagion has been spreading to France, and that's another very big domino to fall.

On the longer term, which was your question, I'm personally quite optimistic that this crisis ultimately will result in significant changes in a number of European societies towards more competitiveness, more opportunity, more flexibility, and better patterns of investment and use of capital. I think there is a lot of scope for euro area countries to reform. They have not enough competition in many segments of their economies, and clearly somebody like Mario Monti [prime minister of Italy] can embody that, in the Italian context. He's a former Competition Commissioner, he's a man who is extremely committed to the notion of new entrants in the economy, innovation and basically dismantling the rigidities that exist in so many continental European countries, not only Italy. He has proven it when he was Competition Commissioner among other things, and in his writings throughout.

So you can make this optimistic case. It's too early of course to see facts on the ground, but it's not impossible that the crisis would result in that sort of reform, and therefore enhance your growth potential. But once again, in the short-term, we have a very destructive dynamic at play, and it's not easy to see how the euro area will overcome it.

Steve Weisman: Why should we be concerned that, even though the markets are impressed with recent developments in Italy, contagion can now spread to France?

Nicolas Véron: I think the short answer is the inability of the euro area – not at an individual country level, but at an aggregate level of the entire region -- to come up with decisions that could stem the contagion.

Steve Weisman: Mainly on having a finance mechanism that would be big enough to challenge market trends?

Nicolas Véron: I always think of this crisis as being a twin crisis of sovereign debt on the one hand, fiscal crisis, and banking systems, and the financial systems on the other hand. These two crises, banking crisis, sovereign debt crisis, feed each other and are increasingly difficult to disentangle. You have this deadly connection between sovereign credit and conditions in the banking systems in the different member states, which has created a connection – created by guarantees, implicit and explicit, by the member states on their banking system, and holdings in the banks of sovereign debt portfolio of the home country, with an enormously high home bias in countries like Italy, Greece, Spain, and Portugal.

I think you need to break that link to create guarantees on the financial systems that are at the aggregate euro area level rather than domestic level and to perhaps swap the assets that are too much linked to the domestic sovereign in the banks' balance sheet for broader euro area assets, if you want to get a functioning banking system. At this point, we don't have a functioning banking system in the euro area. The intra-bank market is totally impaired, the ECB [European Central Bank] is doing massive intervention, and even this is not sufficient, as the case of Dexia showed. The cleaning up of the banking system with the stress test has been, generally speaking, not successful.

So, we have all these factors combining. I think that once again, the core of the failure to stem contagion is the lack of executive decision-making capability, which is a problem of perhaps leadership and competence, but more of accountability. There is no ability to make decisions that you can impose on the very diverse euro area member states, and I think the last summit was a very good example of that. They decided on a bank recapitalization plan that was misconceived, and is probably not going to be implemented. It decided on a new mechanism for the European Financial Stability Facility that is not going to be implemented. We almost know it for sure now for the part which is the special purpose vehicle. And we will see what happens with the credit enhancement part. And it decided on a scheme of haircuts for Greece, which is still under negotiation. So, we see this basically dysfunctional decision-making process at the euro area level, which I think is very hard as a crisis beyond the individual problems of Greece or Italy or others.

Steve Weisman: And yet the markets have stabilized for at least Italy.

Nicolas Véron: If you consider that current Italian spreads are stable, you can say that. I mean, clearly spreads have been reduced today from yesterday, but they remain extremely high. They are much higher than they were a week ago, and I wouldn't be reassured, and certainly wouldn't see room for complacency from the past hour's market developments.

Steve Weisman: Since this is taking place hour by hour and day by day, I'll come back to you and ask for an update. Thanks, Nicolas.

Nicolas Véron: Thanks to you.

