Europe: A Pause in the Crisis? Part I

Nicolas Véron says that because of recent actions by Greece and the European Central Bank, the threat of a breakdown has lifted at least temporarily.

Steve Weisman: Has the threat of a European meltdown receded this summer? This is Steve Weisman at the Peterson Institute for International Economics with Nicolas Véron of the Institute and also Bruegel in Brussels to give us an update. Nicolas, it seems that although it goes in fits and starts, the crisis has stabilized some. Is that right?

Nicolas Véron: Yes. I think it's right and is mainly due to two big developments of the summer. One is about Greece; the other is about the ECB [European Central Bank]. In Greece, the new government, following the elections in mid-June led by the new democracy, Centre-Right Party, has been able to commit on more adjustment and more reforms than many observers, I think, expected.

That doesn't mean that Greece is off the hook. First, the economy is very bad. Second, a number of these commitments may not be acted upon, as we've seen before in Greece. A question of trust remains. But I think it means that the program is unlikely to be declared completely off-track in the next few months. And that means that in the next few months—and I'm not speaking beyond three, four months —there is a very low likelihood of an exacerbation of events in Greece that would force an exit, as many market participants have considered a possibility.

I'm among those who think that the Greek exit would be extremely disruptive to the euro zone in general and might precipitate an unraveling of the euro relatively rapidly. So this is a very major factor in terms of the timetable and again, this is about the short-term, not the long-term. But I think if we consider the next 3-4 months, the likelihood that there would be a disruption caused by Greece has come down from not too large, I think, but significant--to very low.

Steve Weisman: For the United States and maybe for the Obama administration, a stable situation in Europe must be good news.

Nicolas Véron: Yes, I think that's right. I think there are now some things that couldn't have been said in June, and even in July arguably. I think it's possible now to say there will be no meltdown in Europe before the election, before early November. And of course that's a big factor in U.S. politics.

Steve Weisman: It's sort of like saying, "Well, there will be no Israeli bombing of Iran before the election."

Nicolas Véron: I don't know enough about Israel and Iran, but my total layman's perception is that the risk in that direction is now larger in the timeframe until the election than a meltdown in Europe that would change the U.S. election equation.

Steve Weisman: The second factor has been the actions or statements by the European Central Bank.

Nicolas Véron: Yes. This is first Mario Draghi's statement in London in late July that the ECB will act, if spreads continue to rise. And as he said, "Believe me, it will be enough," which impressed traders a lot. This is sort of natural talking by the president of the ECB. But more substantially after that there have been a number of indications that the ECB was considering a program of intervention into sovereign securities markets and had the near unanimity of support. When this went to the governing council, only Jens Weidmann, the President of the Bundesbank in Germany, voted against, and all the other members, governors of the national central banks, and members of the ECB's Executive Board, including the German member, voted in favor. So, this means a number of different things.

First the ECB is more explicitly ready to act than it appeared before this sequence. Second, the ECB is considering direct intervention in the securities markets, which was played down very much by its previous stance. Third, there is an explicit reference to seniority, and the fact that the ECB would possibly no longer claim a senior status to other creditors in future steps, as it did in the Greek debt restructuring of markets here.

I don't think it's very convincing yet, because market participants have, I think, become more cautious after what happened with the Greek debt restructuring, where the ECB claimed preferred treatment. But it remains to be seen how this signal will be made more concrete by the ECB. But I think it is a very important factor in the financial equation for creditors of the more fragile countries.

And the fourth factor, which is more political, is that in the German context, now there are two voices. There's a German voice at the ECB Executive Board, that is Joerg Asmussen, who is basically in unison with Draghi, and then there is the Bundesbank. But the German debate has become split. It's completely different from the situation we had a year ago, say, where basically the Germans were a bloc in the ECB's constituency. Now it's just the Bundesbank, no longer the Germans, and the German government, including Mrs. [German Chancellor Angela] Merkle, seems to side with Mr. Asmussen more than with Mr. Weidman. Even so, of course, is their closeness in their expression and [they] don't want to undermine the credibility of the Bundesbank.

So all these factors are similarly positive for the market, and also are taken as a signal that the Italian and Spanish situation, particularly, will not be allowed to run out of control in—at least in the next few weeks and months. So all this has to be considered, again, relatively short-term, but that means that in the short term, the down side, the big down side risks are much more under control than they appeared as recently as two and a half months ago.

Steve Weisman: Coming back to Greece, the Germans, of course, have been the prime skeptics of Greek commitments on reform and austerity. What, if anything, impresses you about the Greek commitments that make you at all hopeful?

Nicolas Véron: It's mostly about physical adjustment and reform of the Greek state. Again, all the big questions are about execution. But you look at the pledges, at least there is an impression that the new government is more serious about it than the previous few governments that preceded it. So again, I think what is important is what will get done. How many civil servants, unfortunately, will not be replaced, or will their petitions be suppressed in the next few months. Privatization is difficult, as the Greek prime minister has noted, as long as many politicians around the euro zone say Greece might leave the euro. Nobody wants to buy Greek assets that might be converted into drachmas in the next few months, so this is a difficult situation, privatization, and more generally FDI [foreign direct investments] and investment in Greece.

But even if you look at the European policymakers—I think it changes every week of course—but I would say the center of gravity of the expression of senior policymakers in Europe, and it has to be different shades across country. But at least I sense in recent weeks more of a direction towards, "We won't let it happen, that Greece will exit the Euro zone," as opposed to. "We would prefer Greece to stay," which was much weaker before. The reason for that I think is that more policymakers are waking up to the potentially very disruptive character of a Greek exit. Because basically what this says is that the euro zone is here to stay, but what does that mean? That has to mean that the euro zone is here to stay for people who use the euro. So if you can kick a country out, basically does this assertion mean the Euro is here to stay but only for a part of the users, which is a very weak commitment.

So I think all these very simple things are becoming clearer now in the mind of a number of policymakers. Of course it doesn't remove the big question, which is: if Greece doesn't deliver on its commitment, what is the next step? What can the euro zone, the other euro zone countries do to prevent moral hazard? And I think we still don't have a clear response to this question.

Steve Weisman: I'm going to stop there, and invite readers and listeners to a second part of this conversation, on the progress on European banking supervision.

Nicolas Véron: Thank you.