The ECB's 'Firewall': Has a Corner Been Turned? Part II

Jacob Funk Kirkegaard and Edwin M. Truman explain the role of the International Monetary Fund in Europe and assess the obstacles that are crucial to overcome in the next several weeks.

Transcript of interview recorded September 7, 2012.

Steve Weisman: In the wake of the European Central Bank's announcements of a firewall and other measures in Europe, this is Steve Weisman with Edwin M. (Ted) Truman and Jacob Kirkegaard at the Peterson Institute, continuing our conversation analyzing the results. Was there anything interesting in the announcement today about the role of the International Monetary Fund?

Ted Truman: I think that was very interesting, because it was left somewhat ambiguous. [ECB President] Mario Draghi was very careful to say they would seek IMF involvement in these newer programs, potentially, for at least Spain and Italy. But they couldn't dictate to the Fund whether the fund would accept that. But he invited both advice on design and monitoring, and in answer to a question, he also said, "Of course, we welcome their money too."

So he left all the options open but respected the IMF's role in all this. But it's pretty clear that, assuming the political forces within Europe are inclined to that direction, you could have a program "approved" for, say, Spain, that had no substantial substantive involvement of the fund. So he had it both ways.

Steve Weisman: Can you have it both ways? Jacob, it's almost like IMF involvement is a poisoned chalice for Europe, that its entry spooks the markets because of these issues of the seniority of its credit.

Jacob Kirkegaard: A lot of this concern among market participants about the seniority of the official sector, and not least the seniority of the European Central Bank in these interventions, is somewhat overblown, in my opinion. One of the things that the ECB also made clear today is that the interventions that they may be making on behalf of Spain or Italy, will in fact be pari passu with private investors.

Steve Weisman: Would you like to explain that in English?

Jacob Kirkegaard: It means is that in a hypothetical bond restructuring in the future, the ECB would face the same haircut as a private investor. They didn't go into details about how specifically in legal terms this would be achieved, but this obviously would put the ECB at a very different entry point with respect to the IMF. In my opinion, there can be no consideration that the IMF [would give] up its super senior status, vis-a-vis private investors.

But again, in the two countries in question, Spain and Italy -- which I regard both as fundamentally solvent -- I don't believe that the potential involvement of IMF, with IMF financing, would be such a poisoned chalice, quite frankly. But this is a matter for some discussion.

Steve Weisman: Ted Truman?

Ted Truman: I think it is more political than substantive. I agree with Jacob on this point. In a certain sense even talking about seniority suggests that the program is going to fail. That I think is actually a bit of a problem, and I think the real issue is the political problem if Spain or Italy just can't absorb the fact that [they] would be back under the thumb of the IMF as they were in the 1970s. It's too far back to roll the wheel. I think the seniority question is a bit of a red herring in this context.

Steve Weisman: Jacob.

Jacob Kirkegaard: I completely agree with Ted on this issue, that the domestic political stigma, if you like, for a [Prime Minister] Mariano Rajoy [of Spain] or a [Prime Minister] Mario Monti [of Italy] would be increased if this became viewed in the press and in the public debate as a full-blown troika program, rather than something "less serious" than what Greece, Portugal, and Ireland are currently undergoing, It ought to, in the minds of these governments, certainly reflect the fact that neither Spain nor Italy have completely lost their market access, with respect to rolling over their bonds.

Steve Weisman: What are you looking for in the next weeks and months that might suggest that Europe is turning a corner?

Jacob Kirkegaard: I think today was a significant step. I think next week we're going to have another significant step forward with the publication of the proposals by the European Commission for a banking union in the euro area, potentially with non-euro member countries. Then I believe that the Spanish government at least is going to be making an application for precisely the kind of support that was made possible today by the ECB. I believe that they will do so before the next EU Council meeting, which is in mid-October. I think we will have a Spanish application for this in the next two to three weeks.

Steve Weisman: Presumably they will have accomplished whatever conditions are possible.

Jacob Kirkegaard: Yes. There will be an application, and there will be a relatively short period of debate about potential additional conditionality. But most of the conditionality, the fiscal austerity, etc., has already been implemented or at least announced by the Spanish government. So, I think that we could see this new policy tool. In fact, I suspect we will see it used within the next one month to six weeks.

Steve Weisman: Ted Truman, are you concerned that there might be some speed bumps or worse along the way?

Ted Truman: Of course there could be speed bumps and a lot of accidents. There's the German Constitutional Court, there is the Greek program itself. There is the political direction in many of the European countries. Italy was already mentioned, Germany is coming up, the Dutch will have an election and an extensive negotiation of a new government.

If they had to make a decision, that will be if not a speed bump, at least a slow process. The real question is whether this sequence of decisions will be set in motion in a way that can sustain a movement away from what [ECB President] Mario Draghi referred to as a bad equilibrium that several of these countries have found themselves in as of the middle of July.

We really won't know for six months whether that move was sufficiently permanent, so that the situation will have turned the corner. I thought that language was very significant today. I thought the other thing interesting was that he actually acknowledged in an indirect way that the monetary union was broken. That really was the basis on which they made the decision.

The real question is whether that could be knit back together, whether you can rebuild the inter-bank market without having essentially the ECB be the inter-bank market among all the banks.

Steve Weisman: When you say the monetary union is broken…

Ted Truman: The functioning of markets has been such that you have had essentially reversion to national markets, and some of those national markets were essentially not working at all. The notion that you had a common monetary policy that would have essentially one set of interest rates across the country for borrowers and equivalent standards. Such equivalent circumstances applied, as opposed to borrower-lenders saying, "We have to worry about whether you're going to be in the euro before this obligation matures."

Steve Weisman: Gentlemen, thank you very much.