Europe on the (Way Back From the) Brink

Comments on Boone and Johnson (2011)

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Key Messages in B&J

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1. Europe (markets) has relied on "moral hazard/no default" to fund itself via bank lending (justify the convergence trade) – CORRECT

2. Ending "moral hazard/no default" in a highly integrated, but undercapitalized, eurozone financial system risks "bank runs" – CORRECT

3. The European System of Central Banks/ECB acts as an "opaque bailout mechanism" that cannot continue to hold the euro area together – FALSE

4. Ending the "moral hazard/no default" will quite likely require "euro-lira", widespread euro area sovereign defaults and bank recapitalizations – Debatable

ECB/ESCB – Not an "Opaque Bailout", But A Functioning Currency Union

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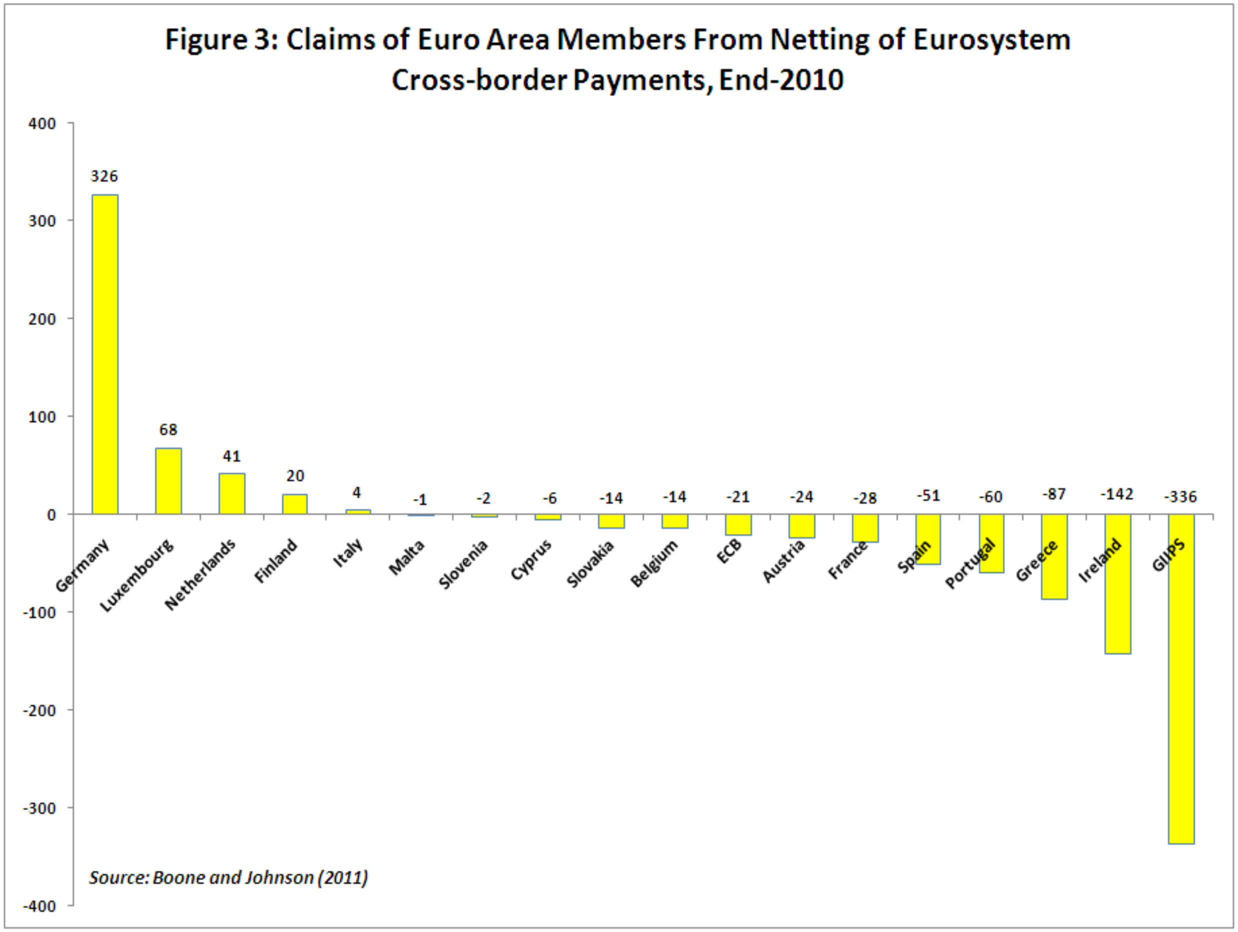
1) Automatic reflection of cross-border base money movements in a currency union with decentralized credit provision to banks

2) Positive Net TARGET2 = claims against all ESCB

3) If Banque de France Had a €326bn positive TARGET2 balance, risk to Germany the same

4) Lack of German private bank lending + peripheral bank dependency on ECB liquidity = imbalances



5) ESCB balance sheet risk (SMP €74bn + GIIPS repos ~€310bn) is lower than frequently asserted, as ESCB capital (July 2011) €81bn + €317bn in "Revaluation Account" + seigniorage

Europe's Repeated "First TARP Votes" to End Moral Hazard

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#1: October 18th 2010 Deauville Declaration:

"providing the necessary arrangements for an adequate participation of private creditors"

November 12th 2010 EU-5 Finance Ministers:

"we are clear that this does not apply to any outstanding debt and any programme under current instruments. Any new mechanism would only come into effect after mid-2013 with no impact whatsoever on the current arrangements"

#2: Euro Group Conclusions June 20th 2011:

"Ministers agreed that the required additional funding will be financed through both official and private sources and welcome the pursuit of voluntary private sector involvement in the form of informal and voluntary roll-overs of existing Greek debt at maturity for a substantial reduction of the required year-by-year funding within the programme, while avoiding a selective default for Greece."

EU Council Conclusions Today…… ? – But the ECB is winning the argument

How Europe Actually Intends to End "Moral Hazard" in the Long-Term

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ESM Treaty Article 12.2;

"An adequate and proportionate form of private-sector involvement shall be sought on a case-by-case basis where financial assistance is received by an ESM Member, in line with IMF practice…….The nature and the extent of this involvement shall depend on the outcome of a debt sustainability analysis and shall take due account of the risk of contagion and potential spill-over effects on other Member States of the European Union and third countries……"

1) Ultimately, it seems most likely that the EFSF (e.g. existing Greek, Irish and Portuguese IMF programs) will get the same formula for PSI that the ESM ended up with

2) Potential precedent from Greece to Portugal (€26bn end-2014) and Ireland (€12bn end-2013) IMF Program underfunding, although lower EFSF loan rates will reduce these levels

Where is the Crisis Pushing Europe?

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Euro Area Level:

1. More integration – Euro-IMF; embryonic economic union
2. Conditional Eurobond (ESFS/ESM/ECB SMP)
3. Stealth Transfer Union

Euro Area National Level:

1. Irish & Portuguese voters supported IMF programs
2. German opposition (SPD/Green) in favor of "real Eurobond"
3. Generally – EU voters are risk averse and have overwhelmingly supported fiscally conservative platforms since Spring 2010
4. EU populism on the rise, but due to two good factors (not just EU)
    1. Swing to center by Southern center-left parties (New Labour by the Med!)
    2. Massive increases in immigration into the EU-15 (x2 US rate since mid-2000s)