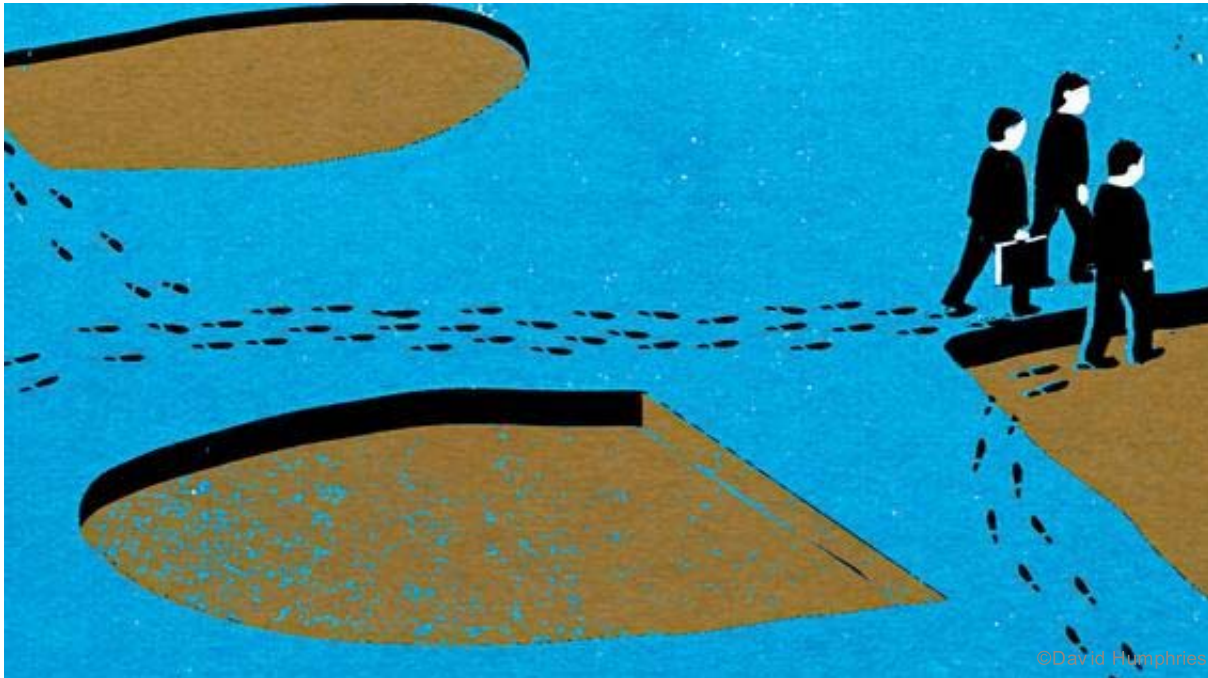


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A step at last in the right direction



By Martin Wolf

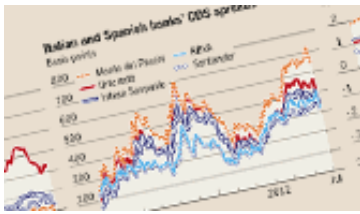


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I was in Ischia, off the coast of Naples, during the latest eurozone summit. Many of the Italians present during the award of this year's Ischia prizes for journalism thought that Italy had won two victories over Germany: in football, at the European championships, and in economics, at the European summit. Then came the football final, against Spain. How much is likely to be left of the summit euphoria a few months from now? The answer, I believe, is: something, but not all that much. The 19th crisis summit was better than many of its disappointing predecessors. But the game has not yet changed.

Helpful steps were taken. The most important were the agreements to allow the eurozone's rescue funds to recapitalise undercapitalised banks directly, rather than provide money via vulnerable governments (of particular benefit to Spain and potentially enormous benefit to Ireland) and to buy sovereign bonds in the market (of apparent benefit to Italy and Spain). It was also agreed that loans from rescue funds would not be senior to existing loans, which should reduce the risk of panics by lenders. Leaders also agreed a €120bn (\$151bn) package of measures to promote growth. On the principle that support should coincide with control, the European Central Bank is to be given responsibility for a new system of European banking supervision, as a step towards what protagonists hope will be a true banking union.

Yet what was not agreed is even more important. The list



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includes any increase in the funds available for the European Stability Mechanism (capped at €500bn); eurozone bonds, in any form; and a eurozone-wide deposit guarantee or bank resolution regime. Beyond this, the challenge of rebalancing competitiveness within the eurozone remains huge and, in the best of circumstances,

long-lasting. Meanwhile, it needs to be stressed, the ECB has no intention of being buyer of last resort of sovereign bonds.

Thus the most important positive element is the movement towards breaking the mutually destructive links between banks and sovereigns. This is a step towards the eurozone equivalent of the US troubled asset relief programme, or Tarp. A consequence must be to take the responsibility for supervision out of the hands of national governments. The result is also going to be a huge further increase in the powers of the ECB. At the same time, this is only a small step towards a full banking union, which would require a bigger fiscal back-up than anything now available. Rational Spaniards and Italians still cannot regard a euro in one of their banks as being as safe as a euro in a German one, largely because elevated insolvency and break-up risks evidently remain.

Meanwhile, the growth package, partly illusory and presumably to be spread over some years, is a mere bagatelle, at barely more than 1 per cent of eurozone gross domestic product. The decision to let the rescue funds buy government debt in the market is even less meaningful and could prove destructive, as the Belgian economist, Paul de Grauwe, now at the London School of Economics, argues in a recent article.

The outstanding debt of Italy and Spain is close to €2.8tn, or a little less than six times the size of the ESM. It is well known from the work on currency crises of Paul Krugman, the Nobel laureate, that speculators can bet safely against a fund known to be too small to stabilise a market. The only credible stabiliser is an entity with infinite firepower. In the case of sovereign finance inside the eurozone, the only entity able to protect a country against self-fulfilling runs on its sovereign debt is the ECB. Since the ECB is unwilling to act in this role and leaders are unwilling to give the ESM the powers to force it to do so, these proposals amount to spitting in the financial winds. Markets may have worked this out: while bond spreads have fallen, they remain dangerously elevated (see chart).

What makes the agreements seem potentially more significant than on face value, however, are that: first, there was actual progress towards a higher degree of integration; and, second, a coalition formed between France, Italy and Spain. The latter suggests that the political dynamic of the eurozone might have altered with the rise to power of François Hollande. It also seems to confirm that Germany does not wish to seem isolated, provided it does not have to concede on fundamental principles. However these shifts certainly do not show that the path to true fiscal or banking unions now lies open. Either would require a far greater sense of solidarity than now exists. For the

reasons I advanced last week, I remain sceptical of the feasibility of agreeing such unions or of making them work, if they are agreed.

In substance, then, these are small steps, incapable of achieving the three necessary conditions for an end to the crisis: a definitive separation of banks from sovereigns; financing of weak sovereigns on manageable terms during the lengthy period of economic adjustment and retrenchment; and, above all, a return to healthy economic growth.

Let us not be too grudging: the decision to allow the ESM to recapitalise banks directly is possibly very important, both in itself and for what it portends. It might transform Ireland's position. Nevertheless, the biggest danger is that the economics of the eurozone are deteriorating fast. Joblessness reached 11.1 per cent in May, the highest on record for the zone. Worse, apart from its refusal to intervene in sovereign debt markets on the needed scale, the ECB is hopelessly late in taking necessary monetary action. With austerity biting in vulnerable countries, everybody is feeling the pinch: even Germany is not immune to downturns in big trading partners. It is conceivable that the eurozone will struggle through this economic trench warfare over the next several years. However, the costs – not just economic but also political – are likely to be enormous.

Yes, the eurozone does need a new constitution. But the priority is to get economies moving. Until then, the risks of further crises remain.

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