Thursday, December 02, 2010

GaveKal Ad Hoc Comment

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A New Idea to Save the Euro

Now that even the president of the European Council has admitted that the Euro is in mortal danger, the fundamental flaw in the single currency project is evident to everybody with the possible exception of Angela Merkel. As both the friends and foes of the Euro project warned from the start, a durable monetary union cannot exist without a significant degree of fiscal union and of collective responsibility for sovereign borrowing – in other words a European "economic government" of some kind.

Both the founding fathers of the Euro and the Eurosceptics, such as the founders of GaveKal, were united in expecting the monetary union to suffer an existential crisis in the absence of a central economic authority capable of organising fiscal transfers and collective borrowing guarantees. The only difference between the Europhiles and Eurosceptics was in the prediction of what would happen after the inevitable crisis occurred:

1. The Eurosceptics expected the Euro to disintegrate as the surplus countries proved unwilling to support those in persistent deficit.
2. By contrast, the founders of the Euro, led by Jacques Delors, noted that the European Project has always progressed through crises and were confident that once the single currency was threatened with disintegration, European nations would be forced to take the decisive steps towards fiscal federalism and economic government which, back in 1991, the Maastricht Treaty refused to contemplate.

This moment of truth has now arrived. Europe's leaders face a choice of "more Europe" or "less Europe". Simply preserving the status quo is no longer an option. The meaning of "less Europe" is obvious, at least in theory—a breakup of the Euro. This is still very difficult to analyse in practice, but no longer "unthinkable" or "impossible to imagine", as European officials invariably claimed even a few weeks ago. Still, before a break-up becomes a high probability, European leaders are bound to try everything possible to defend the monetary union—and with the financial contagion accelerating in a manner ominously reminiscent of Lehman, they will have to act fast. So what could Europe do in the weeks or months ahead?

1—Unappetizing Options

Three options have been widely discussed, but none of them seems to hold out much hope of a solution.

- An ECB programme to buy sovereign bonds, financed by US-style quantitative easing. This programme would have to be of a different order of magnitude to the €70bn of ECB bond purchases so far. To offer convincing reassurance to investors in the multi-trillion bond markets of Spain and Italy, the ECB would have to commit to bond purchases of at least €500 billion, and more likely in the €1 trillion range. Jean-Claude Trichet and the PIIGS representatives on the ECB would definitely support such a "nuclear option" if they felt that the Euro was in mortal danger, but it would risk provoking furious opposition in Germany. German politicians and economists believe with an almost religious fervour that central bank ownership of government bonds is a "sin" and QE is the work of the devil (witness the German denunciations of the Fed at the last G20 meeting). A programme of bond

purchases big enough to inspire "shock and awe" in the markets would therefore, at a minimum, be hugely embarrassing to German policymakers such as Merkel, Schaeuble and Weber, who would have to eat their words of the past few weeks. Quite conceivably, the anger in Germany about ECB bond purchases would provoke the break-up of the Euro it was designed to avoid.

The existing propositions to save the Euro seem adequate and/or infeasible.

- A quantum increase in the guarantees made available by European governments to the European Financial Stability Fund. There have been rumours that Germany might agree to double the size of the EFSF from the €450bn agreed in the wake of the Greek crisis. Given, however, that the true resources of the EFSF are likely to be only €250bn or less, as previous guarantors such as Spain and Italy become potential borrowers, even a doubling would not be sufficient to impress investors once attention moves from Portugal and Ireland to Spain and Italy.
- Large-scale issues of European Union bonds, guaranteed jointly and severally by all EU member states. Such federal bonds would be at least as credit-worthy as the bonds of the US, German, Japanese or British governments and could potentially provide unlimited low-cost funds, managed by the European Commission, for the support of insolvent governments. It is almost inconceivable, however, that Germany would ever agree to extend its credit rating in this way to the entire EU. And even if the German government or Constitutional Court did not veto this vast extension of fiscal federalism, Britain would certainly refuse to participate. The EU would therefore be forced to create a new legal entity to borrow collectively on behalf of the members of the Euro-zone—a process which would require Treaty changes or months, if not years, of complex legal maneuvers.

Given the problems described above with these three conventional solutions, is there another way? After a lot of analysis and debate with policymakers and people in the market, we would suggest another option that could be more effective financially and also more acceptable to political and public opinion, especially in Germany.

2—A Better Way to Save the Euro

But by treating the Euro crisis as the banking crisis it is, perhaps a better solution can be found?

Our approach begins by noting that the Euro now faces two closely related, but distinct, financial threats—to sovereign borrowing and to banking systems. Greece has been pushed into bankruptcy by profligate government spending and inadequate tax collections. But most of the struggling EU sovereigns are threatened by the insolvency of their banking systems, which in turn have reflected unsustainable borrowing by the private sector, reflecting enormous property booms. Ireland's need for a bailout was entirely due to the government's inability to support its insolvent banks and the same will be true of Spain if the contagion spreads there from Portugal as it almost certainly will.

In fact, Ireland and Spain would be among the strongest credits in the Euro-zone if it were not for the sovereign guarantees they have been forced to offer to their banking systems following their property booms and busts. Spain's government, for example, faces bond redemptions of only €15bn before the end of April, but Spanish banks will need to refinance €35bn, creating a total net demand of €50bn. With credit losses of Spanish banks estimated at around €200bn, the banking system is the core of the financial problem faced by Spain. To make matters worse, the Spanish caixas showed core tier 1 capital ratios of only 5.5% in the recent ECB stress tests, implying a huge need for additional capital from the government to bring them up to the 12% ratio established as a benchmark by the Irish bailout. Belgium, probably the next most vulnerable country after Spain also faces potentially catastrophic bank losses. Belgian bank assets total 340% of GDP

and have quite a big exposure to the PIGS. Belgium also has one of the biggest debt roll-over schedules in Europe in 2011. Indeed, as much as €60bn of Belgian debt needs to be rolled over next year, which is more than 17% of GDP.

Once it is recognised that the Euro sovereign debt crisis is to a large extent a banking crisis, a possible solution that sidesteps German (and British) objections to fiscal federalism can be devised. **Instead of a collective system of joint and several guarantees for government borrowing, essentially extending Germany's credit rating to more profligate European states, a better approach would be to create a Euro-wide fund to guarantee and recapitalise European banks and other financial institutions** (especially insurance companies, many of which are even more precariously capitalised and exposed to sovereign bond losses than the banks).

By modifying the terms of the EFSF, one could create a Euro-wide fund to recapitalize the region's beleaguered banks.

A good way to create such a Euro-wide financial restructuring fund would simply be to modify the terms of the European Financial Stability Fund (EFSF), which already allows "*a Member State that receives funds to use them partially for financial support to banks in accordance with the agreed country programme*". In much the same way that the US Treasury had to reconsider its original proposals for the Troubled Asset Relief Program (TARP) and ultimately turned it into a fund for recapitalising banks and insurers, the EU could do the same with the EFSF, creating a large financial restructuring fund that our New York clients have suggested calling the Euro-TARP.

Such a financial reconstruction fund, far from provoking German hostility, might actually be welcome to German politicians and even to German public opinion. After all, German banks are among the most undercapitalised in Europe and most exposed to toxic assets, including the bonds of struggling Club Med sovereigns and the even more dubious bonds of effectively insolvent Irish, Spanish and Greek banks. Moreover, the German federal government has already been forced to budget €150bn for a fund to recapitalise its own insolvent Landesbanken. Sharing the burden of this financial clean-up with other EU countries could therefore be presented as a benefit to German taxpayers and not just a cost.

A Euro-wide financial reconstruction fund would have at least three other attractions, in addition to easing the political objections of German taxpayers to subsidising improvident governments in the Club Med.

Aside from likely winning German approval, there are also a number of other advantages to such an approach.

1. By supporting the restructuring of national bank (and insurance) systems with the full faith and credit of the entire Euro-zone (or perhaps even the entire EU), the Euro-TARP would deal with the fundamental flaw of the Irish bailout (and potentially of a future Spanish bailout): the fact that the Irish economy is too small to support the sovereign guarantees offered to banks that happened to be domiciled in Ireland but raised funds from savings institutions and other banks across the entire EU. As has often been noted, the Euro-zone economy is easily big enough to resolve the problems of its banking systems; but so long as cross-border financial exposures have to be supported entirely by national governments, the uneven distribution of banking liabilities and assets across the Euro-zone creates threats to national fiscal solvency that would otherwise not exist. The harsh reality is that in several European countries, banking systems got too big relative to the size of the underlying economies. This may not be true in France or Italy but is certainly the case in Ireland, Spain and Belgium and perhaps in Germany as well. This is why markets have started treating sovereign borrowers such as Spain and Ireland far more aggressively than their records on public spending and borrowing would appear to justify. Moreover, the national responsibility for bank restructurings and guarantees is highly inequitable, since it forces

Irish taxpayers to pay for bailouts undertaken for the benefit of bank bondholders in Germany, Britain and France. It is as if Bank of America had to be supported by the state budget of North Carolina or Citibank bailed out by the state of Delaware.

2. A Euro-TARP would eliminate the threat of runs on potentially insolvent national banking systems in Greece, Ireland and Spain by offering identical government guarantees for all Euro-zone banks. Such deposit runs from Greek, Irish, Spanish, Belgian and Italian banks into the German or Dutch banks is the event most likely to trigger a break-up of the Euro.
3. Euro-TARP would allow banks to be financially restructured and haircuts to be imposed on bondholders in an orderly and consistent manner across the entire European financial system. Burden-sharing by bondholders would not trigger bank-runs, as it would under the present system, because all banks would be backed by credible collective guarantees from the entire EU or Euro-zone, rather than by national governments whose own credit would be severely impaired—and whose very membership of the Euro would be imperiled—if their domestic banking systems suffered from a severe capital flight.
4. A Euro-wide fund for financial restructuring would provide a mechanism for recapitalising insolvent banks, both by forcibly converting debt into equity and by injecting public funds.
5. The existence of bank guarantees backed by the unimpeachable credit of the entire EU or Euro-zone would allow regulators to conduct realistic stress-tests and to inject large amounts of new capital quickly so as to permit a recovery of credit in the Euro-zone, even if capital requirements were tightened beyond the Basle 3 standards, as demanded by the Irish bailout.
6. A Euro-wide approach to banking would accelerate and justify the unification of European financial regulation, a major objective of both the German and French governments, as well as the European Commission.

3—Conclusion

If the Irish and Spanish governments no longer had to stand behind their domestic banking systems, worries about their solvency would be resolved overnight—and even for the governments such as Belgium, Greece and Portugal with larger purely fiscal problems, a properly-funded external vehicle for recapitalising banks (and potentially also insurance companies) would remove a big threat to financial stability and eliminate the most plausible mechanism for pushing these countries out of the Euro.

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Whether the Euro can survive in the very long term will depend mainly on the willingness of European nations to link their destinies in a tighter fiscal and economic union. There is no ingenious financial mechanism that can ultimately substitute for a decision on whether or not to create a fiscal federation. It would be possible, however, for Europe to delay the moment of truth when this fateful decision has to be taken—potentially for several years. Considering all the other tensions and disruptions in the world economy, a terminal crisis in the Euro-zone is the last thing we need today. Even for Eurosceptics who believe that the single currency is ultimately doomed to failure, delaying the day of reckoning and creating a mechanism to stabilise and recapitalise the European financial system, should surely be attractive at present. That is the spirit in which we present the proposal above.