Eurozone: Are the building blocks falling into place?

by Simon Tilford

On the face of it, September was a good month for the euro. For once, market expectations were met. The European Central Bank (ECB) belatedly opened the way for action to address the ruinous polarisation of government borrowing costs in the eurozone. Germany's Constitutional Court removed the last obstacle to the deployment of the European Stability Mechanism. The Commission put forward proposals for a eurozone banking union. And Dutch voters resisted the clarion call of political populism. Will the market rally that greeted these developments be sustained, or will it prove as transient as previous ones? Cautious optimism is warranted, but more is needed to convince investors of the irreversibility of the euro.

The ECB's announcement prompted a steep fall in Spanish and Italian bond yields and a strengthening of the euro. For many, the ECB had demonstrated that it would do everything necessary to save the single currency. For others, it marked the end of central banking independence and presaged the monetisation of debt and a surge of inflation. The reality is more prosaic. The move certainly marked an unequivocal intellectual victory for Mario Draghi. The Italian won almost unanimous support for the move; Bundesbank chief Jens Weidmann was the only dissenter. But the announcement is less than it appears. And the political stalemate at the heart of the euro crisis remains unresolved.

The ECB's readiness to purchase potentially unlimited quantities of government debt marks a victory for those who have long called for such action to counter the break-up risk responsible for the struggling eurozone economies' inflated borrowing costs. Investors believe that there is a chance that Italy and Spain will ultimately be forced out of the currency union and are thus demanding a hefty premium to insure against this eventuality. This feeds convertibility risk by weakening countries' fiscal positions and raising private sector borrowing costs (government bond yields set the cost of capital for the private sector). The ECB announcement represents an acknowledgement of the perversity of countries in deep recessions paying the highest borrowing costs and a repudiation of the idea that the high interest rates largely reflect governments' credibility problems. Finally, it demonstrates a willingness to act in the interests of the eurozone as a whole, and to isolate Germany if necessary.

However, there are qualifications. A declared willingness to buy bonds will not be enough to bring about a sustained fall in government borrowing costs. For this, the ECB will actually have to buy large quantities of debt. There are some formidable obstacles to this happening. First, any government wanting to benefit from the ECB's scheme will have to sign up to strict conditions. They will not necessarily have to apply for a full programme of the kind in place in Greece, Ireland or Portugal, but they will have to agree to a macroeconomic adjustment programme, which will include fiscal austerity imposed by the Commission and monitored by the IMF.

Second, all 17 eurozone governments will have to approve each programme, opening the way for national parliaments to veto those that are seen as insufficiently tough. In short, Weidmann may have been in a minority of one on the ECB's Governing Council, but the German parliament has an effective veto over the aid programmes that must be in place before the ECB can act.

The need to attach conditionality is understandable; other governments have to be confident that countries whose debt the ECB buys will not slow the pace of reforms. But there is a risk that in the drive to make the programmes acceptable to national parliaments, struggling countries will be required to sign-up to excessive fiscal austerity. The experience of the three countries under the existing bail-out programmes strongly suggests that this would be self-defeating. They have persistently missed their deficit targets as austerity has pushed them into deep economic slumps.

There is little reason to believe that Italy or Spain would fare any differently. For example, were ECB purchases of Spanish bonds to be made conditional on Spain actually meeting the Commission's deficit targets (rather than simply paying lip-service to doing so), Spain would be forced into further cuts in public spending. The result would be a deepening of the country's slump and a worsening of its fiscal position. It is a moot point whether the Spanish would accept a humiliating loss of sovereignty in return for a commitment to buy their bonds if they abide by terms that are almost certain to prove unrealistic.

In reality, the ECB would be unlikely to cease bond purchases if a country did breach the terms of its programme for fear of plunging the eurozone into a potentially fatal financial crisis, but this would present its own set of problems. The spectacle of the Bundesbank being outvoted has already prompted fierce criticism in Germany. If the ECB were to continue with bond purchases in the face of breached conditionality, it would become much harder to win German support for subsequent programmes for other countries. Moreover, it could make it even less likely that the Germans (and others) would agree to the other indispensable institutional building blocks of a solution to the crisis, such as a banking sector union and eventually some kind of fiscal union.

The ECB's move combined with the ESM is not enough to dispel investors' fears over a break-up of the eurozone. The central bank has done as much as the political constraints permit: the ball is now in the governments' court. They must agree a level of conditionality that makes economic sense but which is also acceptable to both sides. This will not be easy: if conditionality is excessively tight, countries are likely to balk at applying for ECB support; if it is deemed insufficiently demanding by others they will refuse to sign off on them. Far from wading into the market to dispel convertibility risk, there is a risk the ECB could end up doing little. And the longer there is no bond-buying, the more fragile the market rally will become.

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Besides, the ECB is powerless to address the core of the crisis: the failure of the eurozone's debtors and creditors to broker an equitable and economically viable burden-sharing agreement. No debt crisis has ever been solved by the debtors being forced to carry the full burden of adjustment, but that is what the eurozone's creditor countries are attempting to do. A workable solution requires the creditors, led by Germany, to make the case for a degree of mutualisation, be it in the form of a fully-fledged banking union or Eurobonds, or a combination of the two. With many Germans smarting at the Bundesbank being outvoted and increasingly fretful about the scale of their exposure to the crisis-hit countries, this would be a tall order for any politician in a run-up to a general election, let alone one as cautious as Angela Merkel.

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