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The Buba is right!

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Once again, the euro crisis threatens to grow out of control. It was reignited by the French elections and by the worsening condition of the Spanish banks and Spanish provinces. Even the Greek election did little to help, since it is becoming increasing clear that Greece will not be able to live up to its promises. Tragically, there is no end in sight. Most states are over-indebted and this cannot be corrected overnight. Moreover, most measures taken so far are aimed at gaining time, rather than dealing with the roots of the problem.

Europe is struggling and several countries are already in a deep recession. Even Germany might fall into a recession by the end of the year. Unemployment keeps creeping up and is since over 11% in the Eurozone as a whole, over 20% in Greece and Spain, and over 50% among young people in Spain. This is a time bomb that threatens social stability and, given the hysteresis resulting from what amounts to be a lost generation, hampers Europe's future growth prospects.

The current situation is characterised by a number of vicious circles that, like whirlpools, threaten to wreak havoc in Europe.

European banking sector is still sick

The European banking sector is quite ill. It holds many bad assets, including sovereign debt that may not be fully repaid. Furthermore, the ongoing recession increases credit risk. The banks must recapitalise or deleverage. This forces them to follow restrictive lending policies, which, in turn, impede activity even further.

The negative feedback loop between banks and sovereign states lives on: weakened banks cannot finance sovereign states, except at exorbitant rates, and governments cannot recapitalise banks, without outside help.

Increasing interest rates in the highly indebted countries make the budgetary situation worse. This raises doubts regarding the ability of states to honour their debts, thus raising interest rates even further. Moreover, falling activity lowers tax revenues and increases statutory expenditures, thus adding to the plight of public finances.

Governments must put their public finances on a credible and sustainable path by aiming at structural surpluses. There is no other way. True, doing so now will worsen the slowdown at first. However, if governments are seen to be determined and trustworthy, markets will give them the necessary time. Adjustment has been delayed for too long and now there is no longer any choice. Some further debt restructuring will probably be unavoidable. So be it. But there is no point in continuing to attempt to buy more time with further bailouts. If the problem is debt, one cannot solve it with more debt!

There is only so much the European Central Bank (ECB) can do. It might have done too much already. By pursuing an extremely – some would say excessively – expansionary monetary policy, it has helped governments, banks, firms and households to refinance themselves. This policy, however, encourages large risks. The money supply has been exploding. Zero interest rates lead to flawed decisions and to misallocation of resources. Nobody knows what the long-term consequences of this policy will be. Europe and the world economy cannot survive on life support for ever.

Is the ECB losing its credibility?
The ECB must beware of losing its own credibility. It is simply not convincing if one day its president declares that it will do whatever it takes to preserve price stability (at a time when inflation at 2.4% already runs above its own definition of price stability), and then a short time later, hints at massive bond purchases, says that it will do whatever is needed to safeguard the monetary union.

Unquestionably, what the ECB cannot do is to bail out states. It cannot be a lender of last resort for governments. True, central banks do have a lender of last resort responsibility, but that is only towards banks – and solvent ones at that – during a liquidity crisis. Printing money to finance bankrupt states is a recipe for disaster. It must not be allowed. It should not even be considered. As history has taught us, it could lead to hyperinflation and a collapse of public institutions. And it would do nothing to convince states to put their finances in order. The problems of Europe are real – lack of competition, lack of growth, overly rigid labour laws, an overextended social safety net, etc. – and thus the solutions must be real, not monetary.

Bond buying by the ECB has done little to help
Bond buying by the ECB in the past has done little to help, except for existing bond holders. The stock is far too large for it to make much of a difference. Luckily, nobody is talking (yet) about buying back the entire stock! The same holds true for the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), which have limited resources. By the way, it does not matter whether purchases are made in the primary or the secondary market, this is a red herring, for given maturities, existing bonds and new bonds are perfect substitutes for one another.

The EFSF and the ESM should hold their fire and keep their ammunition to recapitalise or nationalise banks as needed. It would be wrong to give the ESM a banking licence. Enabling it to refinance itself at the ECB at will would essentially give it a licence to print money. The ECB is right, therefore, to say that the ESM is not a suitable counterparty.

The program announced on September 6, 2012 by the ECB to buy Italian and Spanish bonds, if needed, will only bring short-term relief. The argument that, as long as the bought securities have a maturity of less than three years, the bond purchase program does not violate the ECB's mandate is simply unconvincing and damages the ECB's credibility even further. No matter how you put it, the program does indeed amount to a partial monetizing of public debt. Moreover, the intended sterilisation of the monetary consequences of the bond purchases through the issuance of bills is likely to be ineffective. Given the current near-zero level of interest rates, bills issued by the ECB would be almost perfect substitutes for base money. Replacing one by the other is thus almost pointless. Therefore, inflation risk remains intact.

The question of ECB and ESM seniority is a very hot issue. If it is agreed upon, it will undermine the position of private investors and make them even more reluctant to lend to over-indebted states. If the ECB and the ESM do not have seniority, they will face huge potential losses. Apparently, the ECB is now willing to waive seniority for its new round of bond purchases. European taxpayers, beware!

The Buba is right
The German Bundesbank (Buba) has strongly opposed the purchase of bonds in the past and it continues to do so at present. Its chairman, Jens Weidmann, seems to be almost the only voice of reason to be heard in official circles now that Axel Weber and Jürgen Stark are both gone. Unfortunately, the Buba has only one vote out of 23 on the Council. Even though Germany still carries considerable weight, it cannot stop the tide. The pressure is immense. Indeed, Angela Merkel has given in more than once recently. It is interesting to note that all major international institutions involved are led by Club Med or like-minded representatives: the ECB (Italian president and Portuguese vice-president), the IMF (French managing director and French chief economist), the BIS (Spanish general manager and French deputy general manager), and the OECD (Mexican secretary general). No wonder the prescriptions always seem to be the same: more spending, more borrowing, and more easy money.

In a way, what is surprising is that the euro has not yet collapsed relative to the dollar; and that there has not been more of a bank run in Greece, Spain and Italy. As far as the exchange rate is concerned, this is perhaps due to the fact that there is no reason for the northern euro to collapse relative to the dollar: the euro is Germany's currency, and Germany's economy is in no worse a state than the U.S. economy. As for the bank run, it is probably already under way, except that it is a silent bank run. This is evidenced by growing imbalances of Target 2, the euro payments system. As capital flows from southern Europe to northern Europe, the accounts of the southern central banks at the ECB are debited and those of the northern central banks – the Buba foremost – are credited. Today, the ECB owes the Buba more than 700 billion euro, whereas it holds claims on the central banks of Spain and Italy of over 400 billion euro each. These outstanding amounts have more than doubled over the past two years, creating increasing anxiety at the Buba. If Spain and/or Italy were to drop out of the Eurozone, it is highly possible that these amounts would not be repaid, leaving the German tax

payers with a hefty loss. In a way, one can say that a stealth bailout of massive proportions is already under way. The official bailout programs agreed upon by the EU and the IMF pale in comparison. Moreover, there is no end in sight as suggested by the explosive path followed by these imbalances. And yet, the capacity and the willingness of the Buba to accumulate these claims on the ECB might soon come to an end.

Single European-wide supervisory authority is urgently needed

One fundamental flaw of the European monetary system is that the ECB has little control over the credit expansion allowed for by the national central banks in their jurisdictions. The central banks of southern Europe have been able to refinance banks, accepting just about any collateral. Since 2007, central bank credit to banks in the periphery has been multiplied by a factor of ten, which is unprecedented. This is why a single European-wide supervisory authority is urgently needed, but this might not happen until well into 2013. Till then the recapitalisation of banks by the ESM makes little sense. And so does the bond buying. The Buba is right!



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Ulrich Kohli holds a licence ès sciences économiques from the University of Lausanne (1971), an M.A. in Economics from Queen's University in Kingston (1972), and a Ph.D. in Economics from the University of British Columbia (1976). He has been an economist at the Bank of Canada in Ottawa (1975 – 1977), and an economic adviser at the Swiss National Bank in Zurich (1983 – 1985). In 2001 Ulrich Kohli was appointed Chief Economist and Alternate Member of the Governing Board of the Swiss National Bank (Switzerland's central bank) by the Swiss federal government, a position he kept until the end of 2009. In January 2010 he returned to the University of Geneva as a visiting professor. Ulrich Kohli has published over seventy articles in refereed journals in the areas of international trade, aggregate production theory, economic growth, monetary economics, and macroeconomics.

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