Europe Trip Report: The Train Wreck May Have Only Been Delayed

By Nouriel Roubini

- There are several negative trends in the eurozone (EZ): Increased dis-integration and balkanization within the currency union; a deepening recession in the periphery, while most of the core is close to stalling; and cross-border money leaving the EZ periphery banks, nonfinancial corporates and sovereigns.

- Increased political willingness to move toward an economic, fiscal, banking and political union in the EZ, alongside the ECB’s willingness to provide a bridge of support to Italy and Spain, are two positive developments, but there serious obstacles to restoring growth, competitiveness, external balances, debt sustainability and economic convergence.

- Without banking, fiscal and economic union, a political union is meaningless; and without a political union, the other unions lack democratic legitimacy. Political obstacles are abundant: There is austerity fatigue in the periphery and bailout fatigue in the core; political uncertainty is similarly rife across the EZ. In the meantime, non-EZ EU members have serious objections to the idea of a banking union and have the power to block such a change.

- **Spain** is the EZ country that needs the most official support to reduce the cost of financing itself and deal with its refinancing risk. It is highly likely to negotiate and agree on a memorandum of understanding (MoU) at the latest by November. The major uncertainties that were behind Spain postponing its request for a MoU are gone—the ESM is cleared and the ECB has announced the generous outright monetary transactions (OMT) program of bond purchases—yet Spain is still temporizing for several reasons:
  - There is still some political stigma involved in applying for the financial support from the EFSF/ESM and ECB;
  - Spreads have fallen, October debt redemptions appear manageable and the Spanish authorities prefer to pre-negotiate the MoU to minimize the time between a request and the actual signing;
  - German and Brussels sources have quietly suggested to Spain that it may be a good idea to wait for a couple of months before applying for the MoU, until public and political hostility to the ECB’s recent policy decision (the OMT) has settled down; and
  - The conditionality imposed by the EU-ECB on Spain may not be stricter than that already agreed, but the fiscal targets could be very challenging and it is not obvious the troika, which has already adjusted Spain’s 2012 budget target to 6.3% from 5.3%, would show leniency.

- **Italy** is unlikely to apply for an MoU, at least until after the general election in spring 2013, as the expected ECB actions significantly reduce the tail risk of a rollover/liquidity crisis. Italy still has significant primary market access, if relatively expensive, which implies little need for official
intervention for the time being. Further, the political stigma of asking for official support could be damaging for the government of Prime Minister Mario Monti.

- **Greece**: Germany and the troika do not want to see a Greek exit from the EZ until Italy and Spain are successfully backstopped, ring-fenced and out of the woods, and that will take—at a minimum—another 12 months. However, we still believe a Greek exit in H1 2013 is likely. More probable than the troika/Germany pulling the plug, the trigger for this could be the implosion of internal economic and political dynamics, sparked by a junior coalition member (most likely Pasok) choosing to abandon the government and the austerity program. The ECB and Brussels are fully aware that a Greek exit depends on such political decisions and are sending clear signals a collapse of the coalition would precipitate a Greek exit, rather than a more lenient troika program. If the Greek government can endure and Italy and Spain can be successfully ring-fenced, the EZ will have to make a decision: Either allow an orderly exit of Greece or, if the risk of geopolitical turmoil in the Balkans warrants keeping Greece inside the EZ, then devise a long-term plan to provide a transfer union, and sell such a plan to the German political body.

- **France**: Financial conditions are stable for France for the time being, but there is a significant risk that complacency and policy delays in implementing austerity and reforms may lead to the end of the honeymoon with investors and much tougher financial conditions, at a time when there is an increasing likelihood of a mild economic contraction.

- The prospects for a fiscal union with partial debt mutualization are becoming dimmer as Germany and the core are wary of the associated credit risk, while the rest of EZ is unlikely to accept the veto power on its fiscal budget that would be requested as a condition for any debt mutualization. A more likely scenario is that the ECB’s OMT would work as a substitute for formal debt mutualization. The ECB would eventually phase out its bond purchases, which would in turn be substituted for by the issuance of short-term Eurobills.

- The EZ doesn’t have a strategy to restore growth in the periphery any time soon, while the latest data are confirming a deepening recession. But, without growth, the social and political backlash against austerity may become overwhelming, and debt-to-GDP ratios would keep on rising and become unsustainable. Net exports cannot improve with a now stronger euro and weakening EZ and global growth; government consumption is contracting and increasing fiscal drag; consumption is contracting as falling incomes, rising taxes and reduced transfer payments take a toll on demand; while capital spending by the corporate sector is depressed as excess capacity and weak final demand are prevalent and persistent. Thus, the ECB’s recent actions and the talk about a greater union may have merely delayed, rather than actually reduced the risk of, a train wreck that could eventually lead to the destruction of the EZ.

I have spent the last two weeks in Europe visiting policy makers and others in the main EZ capitals (Berlin, Paris, Rome and Madrid), meeting central bankers at the ECB and Bundesbank in Frankfurt, as well as visiting other European countries (Switzerland and the UK). I and many senior European policy makers also attended the Ambrosetti Forum at Villa d’Este on Lake Como. The following is a summary of my takeaways from meetings with both policy makers and market participants.

**Current Negatives in the EZ: Dis-integration and Balkanization**

Two negative trends in the EZ crisis are of key concern: Dis-integration and balkanization within the currency union. The economic balkanization is ongoing, as the recession in the periphery is deepening, and most countries in the
core are close to stalling. The balkanization of the banking system is also ongoing, as cross-border money, interbank money, wholesale funding and smart money is mostly gone from the EZ periphery. Further, dysfunction within and balkanization of public debt markets is ongoing, as more public debt is being domesticated, in part thanks to the ECB’s actions (LTROs). So, cross-border money is leaving the banks, the nonfinancial corporates and the sovereigns of the EZ periphery.

ThreePotentially Positive Recent Developments

However, there are now three potential rays of hope for the EZ: First, EZ policy makers have realized a monetary union alone is not sustainable: Either you move toward a fuller union and integration, or there will be process of disunion, disintegration, fragmentation, balkanization and eventual break-up. A greater union implies a banking union, a fiscal union, an economic union where growth resumes and growth rates converge; it also requires a partial political union, because the sacrifice of national sovereignty on banking, fiscal and economic affairs to the center/Brussels by a member state requires compensatory democratic power via a political union. Second, the ECB’s willingness to provide—with the new OMT program—a bridge of support to Italy and Spain signifies a first step to a bigger bridge of liquidity, were EZ policy makers come up with a credible plan toward a fuller union. Third, EZ policy makers emphasize now that the EZ is not just an economic project, but also a political one, and that their political commitment should not be underestimated.

Major Obstacles to the Positive Resolution of the EZ Crisis

Despite these positives, there are serious obstacles to restoring growth, competitiveness, external balance, debt sustainability and economic convergence in the EZ, while each of the three developments above is precarious.

First, achieving a banking, fiscal, economic and political union is extremely hard. A banking union is supposed to be easier to achieve than other unions, and would include: ECB supervision of all EZ banks; a direct recapitalization by the ESM bond-buying program of distressed banks; a resolution regime for insolvent banks with an appropriately funded resolution funds; a regime with rules for the bail-in of unsecured creditors; and an EZ-wide deposit insurance scheme. The last element is, of course, “mission impossible” right now, but even the first critical item, ECB supervision of banks, is now a matter of serious disagreement among the EZ members. For example, Germany wants to move extremely slowly on this issue and is arguing that a January 1, 2013, start date for this ECB supervision is not realistic. In the meantime, non-EZ EU members such as the UK, Sweden, Poland and the Czech Republic have serious objections to the idea of a banking union and the power to block such a union, as it requires the unanimous vote of all EU members.

Second, regarding the ECB decision to start the new OMT program, you cannot take for granted that the ECB will start and continue to conduct large-scale purchases of bonds of countries under market pressure without significant assurances. Those in the ECB governing council who were outright against new bond purchases (the Bundesbank) or worried about a new open-ended mandate for the ECB (at least half a dozen central banks in the
core) were not able to stop the new program from being adopted, but they won one clear battle: The conditionality associated with the ECB bond purchases cannot be light, but rather must be strict and effective, and there has to be an exit strategy if a country ends up significantly off course economically, or by failing to adhere to the agreed conditionality.

Third, the political commitment of EZ policy makers to the currency union is not enough on its own: Without banking, fiscal and economic union, a political union is meaningless; and without a political union, the other unions lack democratic legitimacy. Moreover, it is much harder to agree on any form of political union than it is to agree on the economic and financial element of the union. Finally, political obstacles are abundant in both the EZ periphery and the core: There is austerity fatigue in the periphery and bailout fatigue in the core; political uncertainty is similarly rife across the EZ.

Thus, the challenges of restoring economic, fiscal and financial viability in the EZ are still daunting in spite of the above three positive developments. I next consider the challenges of individual countries.

Spain’s Dilemma: To MoU or Not to MoU?

In Spain, economic and financial challenges are becoming more severe: A deepening recession, a serious banking crisis, severe fiscal issues and a fragile policy environment. Spain is the EZ country that needs the most official support to reduce the cost of financing itself and deal with its refinancing risk. And Spain had been the loudest in asking for a larger official firewall, including that provided by the ECB. But now that the major uncertainties behind Spain’s postponing its request for an MoU are gone—the ESM is cleared and the ECB has announced the new generous OMT program of bond purchases—Spain is still temporizing on the decision, which will trigger bond purchases by the EFSF/ESM and the ECB. Why is Spain waiting?

First, there is still some political stigma involved in applying for the financial support of the EFSF/ESM and ECB. Ideally, Spain would have preferred ECB purchases of bonds that were not conditional on an MoU (like the condition-free SMP). Still, Prime Minister Mariano Rajoy would prefer to apply for an MoU after the important regional elections in Galicia in late October.

Second, since the ECB announced in August that purchases may start once an MoU is agreed upon, spreads for Spain (and Italy) have fallen about 200 bps both on the short and long ends of their yield curve, slightly easing the unsustainable cost of borrowing. More importantly, liquidity conditions and the willingness of domestic and some foreign investors to remain invested in Spanish public bonds has increased and, at the same time, Spain has been able to avoid losing market access in the primary markets.

Third, and more importantly, Spanish authorities are worried about the time that it would take to negotiate an MoU after a formal application was submitted. If the process were to drag on for weeks, renewed confidence in Spanish bonds may vanish. Thus, the authorities prefer to pre-negotiate the MoU before a formal application to minimize the time between a request and the actual signing—hence, Spain’s willingness to start pre-negotiations.

Fourth, the hump of €20 billion in public debt redemptions in October is manageable, according to Spanish authorities: Tax receipts are seasonally high in October; Spain has significant cash at its disposal; and market access, especially at the short end of the maturity curve, provides a financing buffer.

Fifth, Spanish authorities worry that the approval of EFSF/ESM funds for Spain by the German Bundestag—a vote by select committees or the full parliament is likely—will get bogged down in a domestic fight about the ECB’s decision to start the OMT. Thus, German and Brussels sources have quietly suggested to Spain that it may be a
good idea to wait for a couple of months before applying for the MoU, until public and political hostility to the ECB decision has settled down. There is a risk that German Chancellor Angela Merkel may lose her “chancellor’s majority” in a vote on aid to Spain, thus, it may be a wiser path of action for Spain to wait until November or so.

Sixth, Spanish policy makers are irritated that Italy has decided that it doesn’t need an MoU and is trying to decouple itself from Spain. From the political point of view, it would be better for Spain if both countries were to apply for aid, but Italy refuses to do that.

Seventh, Spanish policy makers still harbor the residual hope that a combination of lower spreads and greater market access, together with a more aggressive reform agenda—recommended by Germany—may lead to low-enough spreads and stable-enough financing conditions that Spain may not need to apply for formal help. Most Spanish policy makers know this is wishful thinking and realize that, sooner or later, an MoU is necessary and unavoidable. But, for some, hope springs eternal.

Eighth, the conditionality imposed by the EU and the ECB on Spain may not be stricter than already agreed on fiscal and structural issues. However, the achievement of the fiscal targets may be seriously challenging for Spain, which overshot the 6%-of-GDP fiscal deficit target in 2011, registering a 9.2% deficit, more than a 3%-of-GDP overshoot. The expected EU-agreed target for 2012 was originally 5.3%, an impossible target given the 2011 overshoot. This was recently revised, following a worse-than-expected output contraction, to 6.3%. In 2013, the agreed target is 4.5% of GDP and, in 2014, Spain is supposed to reduce its deficit to 3% of GDP—even a move from 9.2% in 2011 to 6.3% in 2012 implies a 3%-of-GDP fiscal drag on an economy that is already in a severe and deepening recession. In private, Spanish policy makers admit that the 6.3% target is not realistic and that the actual figure could be above 7%. Now, suppose Spain signs an MoU where the one clear quantitative condition is a fiscal deficit of 6.3% of GDP. Then, suppose that the ex-post actual figure is 7% or above; this would be a serious problem as Spain would be in breach of the MoU’s most important quantitative target, the fiscal condition. At that point, Spain would have to take emergency fiscal actions, like spending cuts or tax increases, to push the deficit back to 6.3%, at the cost of an additional drag. Otherwise, the country would be in breach of the MoU and the ECB would have to stop buying Spanish bonds or lose its credibility. Spanish authorities hope that a compromise would be reached: Some remedial fiscal action would be taken ex-post to push the deficit below 7% and, at the same time, the troika would show some flexibility. The Spanish authorities suggest that three exogenous factors account for the fiscal slippage in 2012: Worse-than-expected economic growth; a weakening of EZ and global growth; and a breakdown of the traditional elasticity of taxes to income, i.e., a fall in tax revenue in excess of what can be explained by the fall in output. This last factor could be explained by an increase in tax avoidance, as the recession has exerted stress on the cash flows of households and businesses, while tax rates have been increased. However, it is not obvious that the troika, which has already adjusted Spain’s budget target to 6.3% from 5.3%, would buy such arguments and show leniency. Thus, one of the risks of applying for an MoU is that the fiscal target, first and foremost, could not be achieved. The same holds for the 2013 fiscal target: Spain has agreed to reduce its deficit to 4.5% of GDP in 2013; if the 2012 actual were—as likely—closer to 7%–plus, achieving the 2013 target would be even more challenging.

At the end of the day, Spain is highly likely to negotiate and agree on an MoU at the latest by November 2012; the recent honeymoon with the markets, evident in a reduction in sovereign spreads, already seems to be fraying and the country cannot afford to again get caught in a vortex of rising yields and spreads. That is why many in the ECB and parts of the EZ (France, for example) strongly recommend that Spain move fast without further delay. Senior policy officials in Spain’s Economy and Finance Ministry recognize that an MoU prompting ECB action is necessary and desirable.
Indeed, in spite of the potential relief on spreads from the upcoming OMT, Spain’s fundamentals remain dismal: The recession is deepening and front-loaded fiscal austerity is making it worse; the agreed fiscal targets look like mission impossible, given the deepening recession; there is now a serious rift between the central government and some regions like Catalonia, where the independent forces are gathering strength; the unemployment rate is almost 25%, nearly 50% among the youth; the real estate and housing bust is ongoing, as housing is depressed and prices are still falling; the capital hole in the banking system could end up being larger than €100 billion, even if the authorities now argue that their transparent process of auditing the banks suggests that the total capital gap will be less than €60 billion (so that some of the €100 billion allocated by the ESM for Spanish banks could instead be used to fund the government); many more painful structural reforms will have to be approved and implemented before potential growth can increase. Thus, economic, fiscal and financial conditions—as well as social and political dynamics—are worsening in Spain.

**Italy Is Not Likely to Apply for the MoU**

Unlike Spain, Italy is unlikely to apply for an MoU, at least until after the Italian general election in spring 2013. Senior Italian policy makers are adamant that they will not apply for the EFSF/ESM and ECB support. Their arguments are several.

First, Italy’s economic and fiscal conditions are much better than those of Spain (with the exception of the stock of public debt): Italy has a large—3% of GDP—primary surplus, while Spain has a large primary deficit; the unemployment rate in Italy is half that of Spain; Italy did not experience a housing/real estate boom to the extent of Spain; and Italy doesn’t have a huge fiscal bill as a result of cleaning up its banks because, unlike Spain, it has not had a systemic banking crisis. Thus, Italy is trying to make the argument that it is in better shape than Spain and should not be lumped into the same basket.

Second, the halo effect of the ECB decision to start the OMT program has already led—since ECB head Mario Draghi’s speech in London in July—to a significant reduction in Italian spreads, about 200 bps on both the short and the long ends of the yield curve. For Italy to borrow at 5% at a 10-year maturity and to borrow between 2% and 3% at a two-year maturity is something that, for the time being, is fully manageable. Also, the expected ECB action significantly reduces the tail risk of a rollover/liquidity crisis (for example, failed auctions). Italy still has significant primary market access, if relatively expensive, which implies little need for official intervention for the time being.

Third, the political stigma of asking for official support could be damaging for the Monti administration. The government is nominally supported by both the center-left party (the Democratic Party or PD) and the center-right party of former prime minister Silvio Berlusconi (Polo della Liberta or PdL). But the PdL has been recently critical of Monti, as Berlusconi is positioning himself to run again as the head of his party in the spring election, while the PD has remained supportive of the government. Monti, his government and the PD are concerned that asking for an MoU would expose them to attacks from Berlusconi and the PdL; the latter would argue that an official rescue would constitute failure on Monti’s part. To minimize this political risk, Monti and the PD don’t want to apply for an MoU that they see as unnecessary for the time being.

Fourth, senior Italian policy makers make the argument that Italy is now considered an equal partner in the ongoing EZ debates in Brussels, Berlin, Paris and Frankfurt, given Monti’s strong international reputation. Thus, the country’s newly gained leverage would be damaged if Italy were to become a recipient of official resources from the EFSF/ESM and ECB.
One cannot rule out Italy eventually applying for an MoU, after its general election in spring 2013, or earlier, if an early Greek exit from the EZ were to lead—as is likely—to significant financial pressures on Spain and Italy. But, for the time being, Italy is not considering the MoU option.

Although Italy is showing signs of an improvement in its overall financial market conditions, the economic and fiscal situation remains fraught. The recession is actually becoming more severe (see the latest dismal PMIs for September), and a deeper recession will blow the 1.7% deficit target for 2012 well out, with a risk that the actual figure will be closer to 3%, while the public debt burden is likely to reach more than 125% of GDP, according to both IMF and RGE forecasts. Meanwhile, structural reforms are occurring at a snail’s pace, as Monti’s technocratic government relies on the parliamentary support of both the center-left and center-right parties, and the economy’s long-term growth outlook remains very weak.

Also, there is lingering uncertainty about the results of the next election. It is likely that some variant of “Montismo”—i.e., policies of austerity and gradual structural reform—is the likely path ahead. Monti could even continue as prime minister at the head of a grand coalition of the center-right or center-left, or Monti and his technocratic ministers could be part of a center-left coalition government (the PD, plus some centrist parties) if the center-left secures enough votes to run such a coalition. It is highly unlikely that a center-right coalition led by Berlusconi will run again the country, as Berlusconi’s reputation has faded and his PdL party is starting to fragment. Still, forces that are skeptical of Italy’s membership in the EZ (such as parts of Berlusconi’s PdL, the Northern League and the new populist Five-Star Movement) are significant in Italy and getting more popular support.

**Greece May Hold On for Another Year, but Exit Accident Could Occur Earlier**

Germany and the troika do not want to see a Greek exit from the EZ until Italy and Spain are successfully backstopped, ring-fenced and out of the woods, and that goal will take—at a minimum—another 12 months, if not much longer. So, while there are plenty of forces in Germany—even within the governing coalition (see the CSU and FPD)—that would be willing to pull the plug on Greece soon, the leading German policy makers (at least those that matter, namely Merkel and now even Finance Minister Wolfgang Schäuble, who had been toying for a while with the idea of an orderly Greek exit) hold the view that even an orderly exit of Greece is too risky until Italy and Spain are safe. So, while Germany and the troika will play hardball with Greece, they will need to compromise and keep Greece on a program. The troika will push Greece to achieve its program targets, even if implementation will fall well short of the goals, in part because of a deepening recession that is turning into a depression. The troika will ex-post fudge the review of the program and allow Greece to keep on receiving financial support, as long as there is meaningful effort—if not success—toward achieving the program targets. The question of how to provide more financing to Greece in the event, as is likely, of the program goals being stretched out for another two years can be resolved with creative solutions that do not require a third bailout and vote by the German Bundestag on additional bailout resources for Greece: Front-loading some of the already available resources to 2013; some direct and indirect forms of OSI (official-sector involvement, after PSI); and more use of emergency liquidity assistance.

However, we are still of the view that the exit of Greece in H1 2013 is likely. The trigger may not in fact be the troika or Germany pulling the plug on Greece but, rather, internal Greek economic and political dynamics imploding. The recession is fast becoming a depression, as more fiscal austerity will be imposed in 2013 and 2014; Pasok, the junior partner in the coalition with New Democracy, has paid the price for supporting the very unpopular austerity measures (losing its electoral base to the left-wing Syriza), while, as a junior member of the coalition, it is not even in charge of governing the country. So, the costs Pasok is paying for supporting the government are increasingly high and the benefits are shrinking. In the next six months, Pasok (or even the smaller
Democratic Left party) may abandon the coalition, leading to the collapse of the government. At that point, even before a new election could be held (which Syriza would win), a run on Greek banks would take place and an exit from the EMU would become unavoidable. The ECB and Brussels are fully aware that Greece’s EZ future depends on political choices made by Pasok and its leader Evangelos Venizelos, and are sending clear signals that, if the party ceases to support the government and the austerity program, then that would precipitate a Greek exit, rather than a more lenient troika program, with Pasok taking the blame for a disorderly Grexit. It is not clear who will blink first in this game of chicken between the ECB/EU and Pasok. If the latter call the ECB/EU’s bluff, a Greek exit would be assured by the middle of 2013, before Italy and Spain are out of the woods.

Conversely, if the Greek government can endure and Italy and Spain can be successfully ring-fenced, Germany and the rest of the EZ will have to make a decision: Either allow an orderly Greek exit or, if the risk of geopolitical turmoil in the Balkans warrants keeping Greece inside the EZ (as most geopolitical strategists in Germany argue), then EZ policy makers must devise a long-term plan to provide a transfer union for Greece, then sell such a plan to the German political authorities. That option would become more likely if the result of the German elections in the fall of 2013 leads—as is likely—to a grand coalition between the currently governing CDU and the SPD (the German Social Democratic Party).

France on the Cusp: A Core or Periphery Country?

France is currently enjoying a honeymoon with the bond vigilantes—its short and long yields and spreads are very low—not because its economic fundamental are strong and not because of a credible plan to implement fiscal austerity and structural reforms, but because French institutional investors who have cut their exposure periphery sovereign debt are now allocating a greater share of their fixed-income portfolios to French government bonds. A return to home and home bias—more than sound policies—explain such low yields. The new government of President Francois Hollande is less populist than was feared before the election, with a number of mainstream folks and ENA-trained technocrats/bureaucrats in charge. The government wants to achieve a balanced budget by 2017 and has already started to control spending, also starting a dialogue with the trade unions and employers’ associations to discuss the need for structural reforms—crucial to increasing France’s competitiveness and productivity growth.

But many problems are brewing in France. First, the economy is reaching a growth stall: GDP growth this year will be close to zero and could actually be negative next year if some fiscal austerity is credibly implemented. Thus, the unemployment rate is already starting to rise, while the economy stalls or contracts. Second, Hollande was not elected by his base to pursue austerity and reforms, but rather to boost growth and hiring in the public sector; unions are already becoming restless, while the Peugeot factory case, the beginning of new riots among some poor and disaffected minorities and the crackdown on illegal Roma camps suggest brewing social and political stresses. Industrial relations in France between unions and employers are, unlike in Germany, highly conflictual, while government ideas on how to improve them, via labor-market reforms, remain, for the time being, only ideas, far from being implemented. Third, the road to credibly achieving a balanced budget is very bumpy: The economic contraction will increase the cyclical component of the deficit; most of the current fiscal adjustment is reliant on tax increases rather than spending cuts in a country where the government revenues are already at some 50% of GDP (one of the highest in the EZ); and the tough decisions on how to permanently cut spending in the next five years toward the fiscal targets have not been made. Fourth, some policy decisions—like imposing a 75% marginal tax rate on individuals with incomes above €1 million—are leading to dismay in the business and financial community, with some prominent people deciding to give up their citizenship and move abroad (as in the Bernard Arnault case). It is worth noting, however, that Hollande has watered down this measure and that the effective
higher marginal tax rate will be closer to 67%. And some estimates indicate that only 2,000-3,000 people will be subject to this tax rate.

Thus, while financial conditions are stable for France for the time being, there is a significant risk that complacency and policy delays in implementing austerity and reforms may lead to the end of the honeymoon with investors and much tougher financial conditions, at a time when the economic outlook is darkening (there is an increasing likelihood of economic contraction). Note that September’s flash manufacturing PMI was particularly bleak, falling to 42.6, with the composite PMI falling to 44, signaling that France is entering a recession.

**From OMT to Eurobills Rather Than a Wider Debt Mutualization?**

What is the outlook for a fiscal union? There has been discussion in the EZ for some time about a minimal fiscal union where Germany and the core accept partial debt mutualization, while the periphery accepts control and veto power from the EU on the size of the budget balance. Indeed, any risk sharing of public debt needs to be associated with a credible and strict control of the budget by the EU in order to minimize the credit risk of Germany and the core.

But Germany is still wary, at least prior to its elections in the fall of 2013, to commit to even this form of partial debt mutualization, while many EZ members—starting with France—are not comfortable with giving up so much sovereignty on fiscal affairs to the center. So, finding a compromise on debt mutualization will be very hard. Also, with the ECB now embarking on its OMT program, the need for debt mutualization is somewhat reduced as bond purchases by the ECB are partly equivalent to—and a substitute for—formal debt mutualization. Therefore, the prospects for the adoption of Eurobonds are becoming dimmer.

A possible path may rather be the following: The ECB would start to buy short-term bonds of the periphery as long as the countries concerned stay on track with their MOUs. Then, after the German elections, as long as Italy and Spain are stabilized and out of the woods, the ECB would phase out its purchases of bonds and pass the baton to issuance of Eurobills by the EZ periphery. These Eurobills would differ from Eurobonds in two dimensions: They would be of short-term maturity (two-to-three years) and would only be issued in limited amounts (up to 10% of the GDP of any EZ member). Their short-term maturity would reduce the moral hazard involved in partial risk sharing. Thus, the ECB could—in this ideal scenario—shed its holdings of short-term bonds purchased under the OMT program and the stock of such bonds held by the ECB would end up being substituted with short-term Eurobills of similar maturity (up to three years). Of course, this scenario would require Italy and Spain to have moved out of the woods, while Portugal and Ireland would be closer to regaining market access (a condition for any future ECB purchase of their bonds). Of course, if things go south for Italy and Spain rather than improve, purchases of their bonds by the ECB would saddle the latter with a significant amount of credit risk (as the distressed EZ members would not have the resources to pay back the ECB when the bonds mature); and, at the same time, Eurobills would then not be issued.

**Still No Credible Plan to Restore Growth**

Although the talk and progress on banking, fiscal, economic and political union, together with the ECB’s new willingness to support some periphery countries’ bond markets, has partially stopped (but not reversed) the process of the balkanization of banks and public debt markets, the recession in the EZ periphery is deepening and even the core is close to stall-speed. Without a resumption of growth (in output, incomes and jobs), the current strategy of allowing adjustment (via austerity and reforms), together with large-scale official financing, to occur over the next few years may not be viable. After several years of recession, households in the EZ periphery may be willing to tighten their belts for a little longer, but there has to be light at the end of the tunnel in the form of a
resumption of growth in a shorter horizon (the next year or so), rather than several years down the line once adjustment has occurred. Otherwise, the social and political backlash against austerity may become overwhelming: Strikes, demonstrations, riots, violence, extremist parties on the right and the left gaining support and, eventually, the collapse of fragile governments. Growth is also necessary to achieve debt sustainability: The EZ economies in distress need to stabilize and then reduce their public and private debts as a share of GDP. But if the denominator of such ratios—GDP—is in free fall, any attempt to work on the numerator will fail as those ratios will keep on rising and become unsustainable.

The trouble is that the EZ may have a plan for banking or fiscal or political union, but it doesn’t have a clear plan for an economic union that restores output growth and jobs. If anything, the current strategy of continuing to front-load fiscal austerity ensures that the economic contraction will persist and become worse. If one considers the components of aggregate demand, it is hard not to despair when trying to work out where a restoration of growth could come from. Net exports of the distressed economies may improve cyclically—as their recessions deepen—but they will still be structurally large. They will not improve structurally as: a) the euro is strengthening again as the ECB’s decisions have reduced the tail risk of a break-up; b) the slowdown in growth in the EZ core is lowering the chances of a trade improvement in the periphery; c) global growth is slowing, further weakening the probability of an improvement in the EZ periphery’s net exports.

How about domestic demand? Well… Central and local governments are retrenching and deleveraging, triggering a growth-depressing fiscal drag; private consumption is still contracting as unemployment rates are high and rising, the credit crunch is severe, and the increase in taxes and the reduction in government transfers are reducing disposable income; the last component of aggregate is fixed investment; but residential investment is either flat—in countries where there were housing bubbles—or falling in the countries where the housing bubble went bust (Spain and Ireland). And, as far as the corporate sector is concerned, there is very little capital expenditure given uncertainties, which are leading to an option value for waiting.

So, an assessment of the various components of aggregate demand suggests that there is no end in sight, for the time being, to the periphery’s economic contraction. The latest EZ PMIs for September confirm this deepening economic contraction in the area as these forward-looking indicators of manufacturing and service activity are back to levels not seen since the global financial crisis of 2008-09: The periphery’s recession is becoming more severe while some of the economies in the core—such as France—are also starting to contract; there is an improvement in business activity conditions in Germany, but the growth slowdown that country has experienced in the past few months is still serious.

And, as pointed out above, if output keeps on contracting, the “Plan A” of buying time for adjustment—austerity and reforms—via large-scale provision of official financing—now mostly via the ECB—is bound to fail. Unless EZ leaders put a growth agenda on the table and start doing something real about it, the increasing risk is that balkanization and dis-integration will continue and that the ECB’s recent actions will merely have delayed (not prevented) the EZ train wreck.