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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

Will Germany Exit the European Monetary Union? (2)

The Constitutional Court Passes the ESM Baton to the Bundestag

On September 12th. the Karlsruhe-based German Constitutional Court ruled that Germany's parliament could ratify legislation to support the establishment of the European Stability Mechanism (the European Union's new bailout fund), provided it adhered to several restrictions. The court stipulated, not only must the Bundestag have veto power over any increase in Berlin's current 190 billion euro contribution to the ESM, but also, any increase beyond that amount would necessitate the prior approval of both houses of parliament. Moreover, as reported in the Privateer: "The court effectively vetoed any move to afford the ESM a banking license by ruling that any borrowing by the ESM from the European Central Bank (ECB) would be incompatible with the prohibition of monetary finance contained in the current European Union treaty. The court also stated that: an acquisition of government bonds on the secondary market by the ECB, aiming at financing the Members' budgets independently of the capital markets is prohibited." Had the Karlsruhe-based court ruled that further German divestiture of sovereignty to the ESM as unconstitutional, it would have required a rewriting the country's constitution; thereby necessitating an immediate national plebiscite. In a crafty sidestep of passing the ESM baton along to the Bundestag now, a German referendum will likely resurface masqueraded as a general election, slated for September 2013.

Four Judges of the Karlsruhe-based German Constitutional Court. Source: Reuters News

The Deutsche Bundesbank Remains Steadfast in Opposition

For the past few weeks, German Central Bank President Jens Weidmann has been involved in an increasingly public debate with European Central Bank (ECB) President Mario Draghi regarding the broadening of the ECB's monetary policy by initiating an unlimited bond purchase plan for distressed EU member states which request a financial bailout and agree to a set of stringent austerity measures. While Mr. Draghi has received the support from the ECB's Governing Council – as well as from Angela Merkel's coalition government – Mr. Weidmann has remained steadfast in voicing his opposition to the policy: "The ECB should be aware that its independence also requires it to respect, but not overstep its own mandate. What is politically desirable and what is economically prudent have not always coincided. Whether we're talking about interest rates, or some sort of non-standard (monetary policy) measures, in the end it always results in the central bank becoming instrumentally involved in fiscal policy objectives. In so doing, government policymakers tend to overestimate the central bank's capabilities by assuming that it can be used, not only for price stability reasons; but also, for promoting economic growth, reducing the unemployment rate and stabilizing the banking system … If a central bank can potentially create an unlimited supply of money from nothing, how can it ensure that money is sufficiently scarce to retain its value? Yes, this temptation certainly exists and many in monetary history have succumbed to it … Monetary policy independence and policy makers who target price stability are necessary, but not sufficient conditions to maintain people's trust in a currency. It is important for trust (purposes) that central bankers, who manage a public good (in the form of) stable money, also explain themselves publically. The best guard against (misguided) temptation in monetary policy is an enlightened and stability oriented society."

For many Germans, the Bundesbank remains the single domestic institution in which they have almost complete confidence. It would be a decided blow to Ms. Merkel if Mr. Weidmann were to become so isolated in his criticism that he felt obliged to resign his post; as did his predecessor Axel Weber and Jurgen Stark, another German monetary policy hawk and former ECB chief economist. In a spirit of fairness, Chancellor Merkel recently remarked to the press: "It is only natural that the Bundesbank president weighs into the public debate about the euro and its future. That has always been the case and it is very welcome." The above notwithstanding, in a telephone survey conducted between July 3rd. to July 8th. by Germany's Bertelsmann Foundation, some 65% of Germans thought their personal financial situation would be better had they not traded the deutsche mark for the euro. Of those Germans polled, 49% responded they would be personally better off if the European Union (EU) didn't exist. However, despite their apparent skepticism about the euro on a personal level, 69% of Germans polled believed the EU was a model for the rest of the world. The definitive euro poll for Germany's increasingly isolationist and nationalistic citizenry will surely present itself 12 months hence.

Greece: Ask Not for Whom the Bell Tolls, It Tolls for Thee

As recently reported in the New York Times, public opposition to austerity budgets has deepened in Greece, with court judges stopping work, medical doctors going on strike and public transport staff along with school teachers planning strike action soon. The moves are a prelude to a general strike called by the country's main labour unions for September 26th. The protests are gaining strength even as Europe's fears of a Greek exit seem to subsiding somewhat. During a recent press conference in Berlin, German Chancellor Angela Merkel stated she wanted Greece to stay in the European Union (EU) reiterating what appears to confirm her steadfast position on the issue: "I think that everyone who is politically sensible will want that too." Faced with rising discontent, Greek Prime Minister Antonis Samaras has been asking Greece's international creditors for more time to impose any new austerity measures, lest the economy, which contracted by 6.2% in the 2nd. quarter, sink further. Mr. Samaras faces an uphill battle, to say the least. At a recent meeting in Athens, Greece's troika of lenders – the European Commission (EC), the European Central bank (ECB) and the International Monetary Fund (IMF) – rejected four billion euros of Mr. Samaras' proposed budget cuts, voicing their skepticism regarding his ability to succeed. The troika remains unconvinced by suggestions for cuts in the health and military sectors and is urging the Greek government to turn to the civil service – a sacred cow and influential voting bloc – which few Greek politicians have been willing to consider. The Greek finance ministry is reportedly considering raising the retirement age to 67 from 65. An agreement on the austerity plan must be reached by early October, before the troika releases a report assessing Greece's progress in reducing its debt – forecast to reach 161% of gross domestic product (GDP) this year – to about 120% of GDP by 2020.

Near the small village of Levidi, Greece – a two-hour drive south of Athens – Gregoris Skouros, 54, stepped out of the sawed-off cargo container on an agricultural plain he now calls home to greet a group of visitors. When a tourist raised the issue on everyone's mind – Greece's future in the euro zone – Mr. Skouros pursed his lips for a long time before responding: "The problem has now gone beyond whether we remain in the euro or not. The issue is: can Greece be fixed? The problems of Greece are so widespread that it would take a Marshall Plan with outside inspectors coming into every government operation and looking over people's shoulders, to make sure that change really happens. Without fundamental changes, Greece may have little hope of being anything more than a ward of the European state for years to come." Attempting to establish a snail-farming enterprise in Arcadia, Mr. Skouros faced obstacles from the outset. Escargots might be a potentially lucrative cash crop, but banks refused to take the risk of granting him a loan. Obtaining a business permit evolved into an 18-month odyssey, with numerous visits to government offices and the occasional request for bribes. Mr. Skouros related: "In Greece, it has always been the case that you pay a bribe – to obtain your driver's license, at the hospital and even when starting a business. Whether or not Greece remains in the euro … corruption, bribery and bureaucracy are weighing on Greece even more than the debt upon which outsiders are so fixated. Are things ever going to change? Probably not without a revolution."

The Pain in Spain Is Far From on the Wane (2)

In an open letter issued last week, Spain's King Juan Carlos de Bourbon implored Spaniards to take "decisive action within a united society at all levels, in defence of the social democratic model that we have all chosen." The King's rare political intervention surfaces amid a growing public anger over austerity measures, tension between Madrid and the regions and signs of gridlock regarding potential euro zone assistance. Moreover, as reported in the Financial Times, Spain's Deputy Prime Minister Soraya Saenz de Santamaria recently remarked to the press that "the government would request a financial bailout if it would not involve new sacrifices and if Spain could be guaranteed that its financing costs would decline." According to German officials, Spain should examine its financing costs and determine if they are sustainable. Only if the Spanish government is convinced that it cannot refinance its maturing debt at any reasonable yield level should it request a bailout program. Meanwhile, Spain's Prime Minister Mariano Rajoy has suffered a decline in popularity after requesting 100 billion euros in financial aid for banks from the European Union, which has yet to arrive because the EU has yet to ratify the establishment of the European Stability Mechanism (ESM). Recent data revealed that bad loans across the Spanish banking sector, resultant from the country's collapsed property bubble, rose to 9.9% of all loans outstanding in July, up from 9.4% in June. With an election scheduled in Mr. Rajoy's native Galacia scheduled for October 21st. some political observers suggest the government may favour delaying any request for a bailout until after that vote.

Spain has the fourth-largest economy in the 17-nation euro zone, almost five times that of Greece and the thirteenth largest in the world. A failure on the part of European leaders to come to Spain's assistance and a failure on Spain's part to execute its ambitious economic reform plans might destroy the European Monetary Union (EMU) and destabilize the global financial system. Spain's most visible challenges are financial and economic in nature: banks devastated by the bursting of a 15-year economic bubble, rising public debt, a steep budget deficit, high and potentially unsustainable government bond yields, a deep recession and severe unemployment. Collectively, they explain why Spain's banking system would have collapsed this year without European Central bank support; why economic growth is unlikely to return until mid-decade at the least and why Madrid bankers think Mr. Rajoy has no choice but to request a formal bailout from his European partners.

However, Spain's national drama is not just about banks and bond yields; it is regional. Madrid is pressuring regions and lower tiers of government to exercise far more fiscal self-discipline. A constitutional amendment, passed last year, requires the regions to observe strict debt and deficit limits, while commanding local authorities to submit balanced budgets. In the 1st. quarter of this year, the budget deficits of the regions accounted for nearly 19% of Spain's general government deficit. As reported in our September 11th. section of The Week That Was: 'Hundreds of thousands of Catalans take to the streets of Barcelona, in an unprecedented show of mass support for autonomy from Madrid; blaming Spain's economic crisis for depressing their wealthy region … Crowds waved red and yellow striped Catalan flags.'

Source: Albert Gea /Reuters

The ruling parties of Catalonia have sought guidance from Brussels on the legality of succession from Spain, requesting a route map for membership as an independent state in the European Union (EU) and the European Monetary Union (EMU). As reported in the Daily Telegraph U.K. Spain's foreign minister, Jose-Manuel Garcia-Margallo, warned: "Catalan secession is illegal and lethal. Spain will use its veto indefinitely, to prevent the region of Catalonia from becoming an EU member." The constitutional crisis has eclipsed the parallel drama of a Spanish bailout request from the European Stability Mechanism (ESM). It is no longer clear whether Prime Minister Mariano Rajoy can complete any austerity agreement with Brussels. Last week, Catalan leader Artur Mas held talks with Mr. Rajoy in Madrid, equipped with a mandate from the Catalan parliament and emotionally charged from an unprecedented demonstration by 1.5 million people in Barcelona on September 11th. Nine million Catalans have an economy the size of Austria's. Mr. Mas demanded an independent treasury for the rich Catalan region, with control over its own tax base akin to the model already enjoyed by the Basques. The Rajoy government retorted that Spain's constitution allows no margin for compromise. Mr. Mas vowed: "Catalonia's parliament will meet next week to think deeply about its next fateful step. Catalonia will follow its (own) path. We have no enemies and we will build our own project as a country."

Finland Vetoes ESM Leverage Options

The European Union's bailout mechanism is almost certain to commence operations next month without the two leverage vehicles that were an integral part of its predecessor fund – the European Financial Stability Facility (EFSF) – because of Finland's concerns regarding its exposure to the fund's potential loans to heavily indebted EU member states. As reported in the Wall Street Journal, the leverage options were designed to allow the euro zone to mobilize far more than the 500 billion euros ($648.4 billion U.S.) lending capacity ceiling on the new bailout fund – the European Stability Mechanism – by offering extra protection to investors. Officials have not disclosed exact figures, but Klaus Regling, chief Executive officer of the ESM, has stated they would allow the euro zone to mobilize in excess of one trillion euros in resources to stem the sovereign debt crisis. Euro zone finance ministers discussed transferring the leverage vehicles to the ESM at a meeting in Cyprus a week ago, however, despite broad support for the idea, objections from Finland blocked any agreement. One European official believes Finland's objectives could be placated. However, with the ESM due to be launched on October 8th. the leverage vehicles won't be included now in the ESM guidelines, which will detail the tools available to the new bailout fund and the conditions for using them. This means the leverage vehicles aren't likely to be available for usage if a broader Spanish request for a bailout from the ESM were to materialize soon.

Finland's concerns revolve around what the leverage vehicles would mean for the ESM's preferred creditor status, which means euro zone governments would, after the International Monetary Fund (IMF), be the best protected against losses on ESM loans or investments. Finland is concerned that the two leverage vehicles would have reversed that principle through a promise that governments – via the ESM – would have to absorb the first tranche of any losses if there were a restructuring or default. Finland, which accounts for just 1.8% of the ESM's capital, has long been cautious over its exposure to the EU's bailout funds, under pressure from euro-skeptic political groups. Its demand for a separate collateral deal with Greece delayed a broader agreement on that country's second bailout package. It also consummated a side agreement over the summer with Spain concerning its portion of the 100 billion euros of assistance for Spanish banks.

The above notwithstanding, as one of only four AAA rated countries in the euro zone, Finland remains important for the EU's financial credibility. Despite the delay, officials are confident they will manage to placate Finland's concerns. One official stated: "We are still considering the options to maximize the capacity of the ESM. The plans are still under advisement and we expect a solution in the coming weeks." Moreover, while the additional leverage options could prove useful, pressure in financial markets and from the region's international partners for euro zone governments to deploy their own arsenal to stem the sovereign debt crisis, has ebbed in recent weeks since the European Central Bank (ECB) proffered a potentially massive new bond purchase program (outright monetary transactions).

ECB's Outright Monetary Transactions (OMT) Will Punish Equities

In a recent article for the Financial Times, George Magnus, a consultant economist to UBS, notes the principal reason why equities and other risk assets will falter again is because the ECB's bond purchase plan (Outright Monetary Transactions) is economically and politically unsound. Mr. Draghi's insistence that the ECB's actions are dependent upon strict conditions is the price for German and other creditor government support. However, this is precisely the problem. The single-minded emphasis on rapid fiscal restraint has created an unsustainable, pro-cyclical austerity zone. It is undermining weak sovereign and bank funding solvency and substituting national central banks – notably the German Bundesbank – for private investors in financing regional capital flow imbalances, especially deposit flight from the periphery country banks. Political sparks are flying within Germany.

The main flaw in the OMT plan is the presumption that if countries need to apply to the European Stability Mechanism (ESM) for assistance and for the ECB to authorize the OMT's, it is because their austerity programs require strengthening under international monitoring.

This makes no economic sense because it aggravates fiscal and economic instability, plus no political sense because it is highly divisive both within and among EU member countries. There is nothing conducive here to the current meager, but urgent progress needed for a banking union; including both a central resolution authority and pan-European deposit insurance; or for further fiscal integration, including centrally-determined behavioral rules and common debt issuance.

A sustainable recovery in equity and other risk assets would be accompanied by the return of stable, private financing of the euro zone periphery. The weathervane is a sharp increase in German bond yields, making the drift up during the summer just noise. For these events to occur, investors want two things: firstly, adoption of a plan to end the economic depression, which is not likely, and secondly, credible progress towards political union; which requires Germany and France and their supporters to agree upon radically different sequencing and substance agendas when it comes to sovereignty concessions. Mr. Draghi has lured the markets' attention away from these things at the moment, but not for long.

Summary

Inherent within its recent crafty ruling, the German Constitutional Court has, effectively, passed along the decision of whether Germany should remain in the European Monetary Union, to the German electorate for a determination no later than September 2013 – the scheduled date of the next German election. As mentioned, in a July poll Germany's Bertelsmann Foundation determined some 65% of German citizenry thought their personal financial situation would be better had they not traded the deutsche mark for the euro. With each advancing year, more Germans seem to come to the realization that their government can only control Germany's participation within the European Union, and not those of Greece, Portugal, Spain or Italy. Accordingly, we remain steadfast in our belief that the best solution for the European sovereign debt crisis is for Germany to exit the EMU sooner rather than later, because it cannot afford the long-term risk of remaining an EU member. Interestingly, we are joined in this supposition by Alastair Macleod, a senior fellow of the GoldMoney Foundation, who believes a German exit from the euro would enable the currency to drift lower in value, which would represent an attractive option for the indebted EU periphery countries. Correspondingly, such an exit would benefit the German banking system by the redenomination of bank liabilities into a newly minted deutsche mark. Surely, this would give the Keynesian/socialist voices in the rest of Europe the control they probably desire when left to their own devices.

Ian A. Gordon, The Long Wave Analyst, www.longwavegroup.com

"Those who cannot remember the past are condemned to repeat it." Santayana