

## The EU's Monetary Crisis: Europe stumbles blindly towards its 1931 moment

It is the ECB that should be printing money not the US Fed...

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*It is the European Central Bank that should be printing money on a mass scale to purchase government debt, not the US Federal Reserve.*

It was a grave error for Germany's Angela Merkel and France's Nicolas Sarkozy to invoke the spectre of sovereign defaults and bondholder 'haircuts' at this delicate juncture.

Unless the ECB takes fast and dramatic action, it risks destroying the currency it is paid to manage, and allowing a political catastrophe to unfold in Europe.

If mishandled, Ireland could all too easily become a sovereign version of Credit Anstalt – the Austrian bank that brought down the central European financial system in 1931, sent tremors through London and New York, and set off the second deeper phase of the Great Depression, the phase when politics turned ugly.

“Does the ECB understand the concept of contagion?” asked Jacques Cailloux, chief Europe economist at RBS. Three EMU countries have already been shut out of the capital markets, and footloose foreign creditors hold €2 trillion of debt securities issued by Spain, Portugal, Ireland and Greece.

“If that is not enough to worry about financial contagion, what is? The ECB's lack of action begs the question as to whether it is fulfilling its financial stability mandate,” he said. That is a polite way of putting it.

The eurozone's fiscal fund (European Financial Stability Facility) is fatally flawed. Like Alpinistas roped together, an ever-reduced core of solvent states are supposed to carry the weight on an ever-widening group of insolvent states dangling beneath them. This lacks political credibility and may be tested to destruction if – as seems likely – Ireland is forced to ask for help. At which moment the chain-reaction begins in earnest, starting with Iberia.

It was a grave error for Germany's Angela Merkel and France's Nicolas Sarkozy to invoke the spectre of sovereign defaults and bondholder “haircuts” at this delicate juncture, ignoring warnings from ECB chief Jean-Claude Trichet that such talk would set off investor flight from high-debt states.

EU leaders have since made a clumsy attempt to undo the damage, insisting that the policy shift would have “no impact whatsoever” on existing bonds. It would come into force only after mid-2013 under the new bail-out mechanism. Nobody is fooled by such a distinction.

“This is a breath-taking mixture of suicidal irresponsibility and farcical incoherence,” said Marco Annunziata from Unicredit.

“If by 2013 countries like Greece, Ireland and Portugal are still in a shaky position, any new debt issued will carry exorbitant yields. The EU would then have to choose between a full-fledged, open-ended bail-out, and reneging on the promise that existing debt would not be restructured. Will German voters then accept higher taxes to save their profligate neighbours?” he said.

In May it was enough for the EU to announce a €750bn safety-net with the IMF for eurozone debtors. Bond spreads narrowed. A spike in economic output – led by Germany’s rogue growth of 9pc (annualised) in the second quarter – beguiled EU elites into believing that monetary union had survived its ordeal by fire. It had not, and this time they will have to put up real money.

Sadly for Ireland, events have snowballed out of control. Confidence has collapsed before Irish export industries – pharma, medical devices, IT, and backroom services – have had time to pull the country out of its tailspin.

Premier Brian Cowen – who presides over a budget deficit of 32pc of GDP this year – still insists that no rescue is needed. “We have adequate funding right up until July,” he said. Mr Cowan must know this is not enough. Funding for Irish banks has evaporated, and with it funding for Irish firms.

As we learn from leaks that “technical” talks are under way on the terms of any EU bail-out, it can only be a matter of weeks, or days, before Ireland has to tap EFSF – for €80bn to €85bn, says Barclays Capital.

Portugal is in worse shape than Ireland. Total debt is 330pc of GDP. The current account deficit is near 12pc of GDP (while Ireland is moving into surplus). Portuguese banks rely on foreign wholesale funding to cover 40pc of assets.

The country has been trapped in perma-slump with an over-valued currency for almost a decade. Successive waves of austerity have failed to make a lasting dent on the fiscal deficit, yet have been enough to sap the authority of the ruling socialists and revive the far-Left.

Former ministers are already talking openly of the need for an EU-IMF rescue. It is hard to see how Portugal could avoid being sucked into the vortex alongside Ireland. Europe and the IMF would then face a cumulative bail-out bill of €200bn or so. That stretches the EFSF to its credible limits.

The focus would shift instantly to Spain, where economic growth stalled to zero in the third quarter, car sales fell 38pc in October, a 5pc cut in public wages has yet to bite, and roughly 1m unsold homes are still hanging over the property market. The problem is not the Spanish state as such: the Achilles Heel is corporate debt of 137pc of GDP, and the sums owed to foreign creditors that must be rolled over each quarter.

The risks are obvious. Unless core EMU countries raise fresh funds to boost the collateral of the rescue fund, markets will not believe that the EFSF has the firepower to stand behind Spain. Will Germany’s Bundestag vote more funds? Will the Dutch? Tweede Kamer, where

right-wing populist Geert Wilders now holds the political balance, adamantly opposes such help, and might well use such a crisis to launch a bid for power.

It is far from clear what would happen if Italy was forced to provide its share of a triple bailout for Ireland, Portugal and Spain. Italy's public debt is already near danger point at 115pc of GDP. It is also the third-largest debt in the world after that of Japan and the US. French banks alone have \$476bn of exposure to Italian debt (BIS data).

While Italy has kept a tight rein on spending, it is not in good health. Growth has stalled; industrial output fell 2.1pc in September; and the Berlusconi government is disintegrating. Four ministers are expected to resign on Monday.

It is clear by now that IMF-style austerity and debt-deflation is not a workable policy for the high-debt states of peripheral Europe, since it cannot be offset by the IMF cure of devaluation. The collapse of tax revenues has caused fiscal deficits to remain stubbornly high. The real debt burden has risen further.

The ECB is the last line of defence. It can halt the immediate Irish crisis whenever it wishes by buying Irish bonds. Yet instead of pulling out all the stops to save monetary union, the bank is winding down its emergency operations and draining liquidity. It is repeating the policy error it made by raising rates into the teeth of the crisis in July 2008.

Yes, the ECB is already propping up Ireland and Club Med by unlimited lending to local banks that then rotate into their own government debt in an internal "carry trade". And yes, the ECB is understandably wary of crossing the fateful line from monetary to fiscal policy by funding treasury debt.

Bundesbank chief Axel Weber might fairly conclude that it is impossible at this stage to reconcile the needs of Germany and the big debtors. If the ECB prints money on the scale required to underpin the South, it would set off German inflation, destroy German faith in monetary union, and perhaps run afoul of Germany's constitutional court. If EMU must split in two, it might as well be done on Teutonic terms.

All this is understandable, but is Chancellor Merkel really going to let subordinate officials at the ECB destroy Germany's half-century investment in the post-war order of Europe, and risk Götterdämmerung?

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