Dangerous Dysfunction in Europe

Nicolas Véron warns that Europe must attend to weaknesses in its banking system, even as it moves to bail out Greece, Ireland, and possibly other countries.


Steve Weisman: The European financial system continues to be rocked by the problems of several countries in financing their debts and the recent bailout package of Ireland. Nicolas Véron, visiting fellow here at the Peterson Institute for International Economics, is here to talk about the latest developments. This is Steve Weisman welcoming Nicolas again. Thanks for coming.

Nicolas Véron: Thanks, Steve, for having me.

Steve Weisman: The Irish bailout package has brought some stability to the situation, but it also has created the seeds for more concern down the road. What’s your sense of that?

Nicolas Véron: I think investors are more and more concerned by what they see as the difficulty of European policymakers in finding common solutions. There have been a number of policy steps taken by eurozone countries, with the creation of the European Financial Stability Facility (EFSF) after the Greek crisis in May and now with the announcement of the future European Stability Mechanism (ESM). But in the short term, policymakers feel that they are held hostage by the state of the banking systems and the fact that they don’t want to send shock waves throughout the European financial fabric. Therefore they bail everybody out. They bailed out Greek creditors in April. They bailed out senior bondholders of Irish banks in November. There is more and more commitment of taxpayers’ money, so investors want to know where this can end.

Steve Weisman: Where is it going to end?

Nicolas Véron: You need an ability to restructure some of the situations that have been created in “bubble” times. This means an ability to restructure debt, not only sovereign debt, which has focused a lot of attention, but also banking debt, which has been a key factor in the Irish story and also the Greek story. At this point, the response of policymakers is the St. Augustine response, you know: “Give me chastity God, but not now.” They say we will do that restructuring after 2013 and in the case of banks, they say, well, we’ll tackle “too big to fail” [later]. We’ll introduce special resolution regimes. We’ll have all this. But at this time, it seems that no shock is too small to basically be showered with public money to avoid any disruption in this banking system.

Steve Weisman: You mentioned that Europe is held hostage to its banking system. Isn’t that somewhat analogous to what happened in the United States in 2008?

Nicolas Véron: It is analogous to the Bear Stearns situation and, if you will, to the AIG situation when policymakers decided they had to bail out financial institutions to avoid sending shock waves.

Steve Weisman: And the decision to let Lehman fail was the cautionary tale.
Nicolas Véron: It was. It was both a counterexample, because it seems from the report we have that it was a conscious decision to send a message to the marketplace that not everybody will be bailed out. And at the same time, it is a cautionary tale. So basically the lesson the Europeans have kept from that is, you don’t want to do the same thing right now in Europe, which is right. But there is another lesson, which is that you want to increase the resilience of the financial system and of the banking system specifically, in order to be able to withstand bigger shocks. There was an opportunity to do so in 2009, when market conditions were better. That’s exactly what the United States did with the US stress test in May 2009 and subsequent recapitalization. At that time, Europe missed the opportunity—basically did nothing throughout 2009 to make the banking system more resilient. After the Greek crisis in June 2010, they decided that they wouldn’t be caught again at this game, and they decided to reinforce the stress test process, the results of which were published in July. But it ended up being a charade and a process that didn’t bring the needed recapitalization and restructuring. So, we are still in Europe with an extremely fragile banking system—a banking industry [that] hasn’t essentially been properly restructured or recapitalized since the Lehman shock. This is why we have to bail out senior Irish bondholders for Irish banks—I mean they are generally not Irish—so senior bondholders of Irish banks and whoever is at risk of losing money.

Steve Weisman: Do we know who the senior bondholders are for the Irish banks? Which financial institutions for instance?

Nicolas Véron: We don’t have names, but we know that a lot of the stock is held by European financial institutions. But the big impact is not that the haircut on Irish senior debt would create problems per se. It would be a signal that it is possible in Europe to restructure senior debt.

Steve Weisman: Have we reached that point?

Nicolas Véron: Clearly not, because the decision of the EU authorities was to impose upon both to the Irish and to the IMF the conditions that as part of the rescue package last month, there should be a guarantee of this debt. But, again, if they hadn’t done that, the main effect would not be the immediate losses that would have been imposed on some of the holders—it would have been the signal that senior debt can be restructured in Europe. And, therefore, a number of banks that the marketplace considers weak or questionable would no longer have been able to issue such debts. That is the first order issue.

Steve Weisman: If the solution to Ireland is a stop gap that appears designed to give the vulnerable banks in Europe time to strengthen their reserves and even recapitalize, are the banks seizing these opportunities? Will there be another stress test that might guide them on the path to restructuring?

Nicolas Véron: The short answers to your questions are no and yes. No, they’re not seizing these opportunities. They are not taking advantage of this respite to recapitalize, because the most fragile banks actually are not in a position to raise equity in the marketplace, because probably many of them are insolvent. So, nobody wants to invest in those banks. And, therefore, they are kept afloat by the liquidity operations of the European Central Bank, and to a certain extent by government lending. But the interbank market is not functioning for these institutions and the equity markets even less. Basically, you do see some equity issuance, but it is generally of the stronger banks, not of the weaker banks. Typically, you know, Deutsche Bank, Standard Chartered have raised some equity in the past few months after the stress test. But certainly
not the likes of the Landesbanken [German state-owned banks] and the Spanish savings banks or banks [that] are at this point very fragile. Now, to your second question, will there be another stress test? Yes, it has recently been announced that there would be one in February. But at this point the authorities have not made clear how it would end up being more credible and more conducive to restoring investor trust than the largely failed last one in July.

Steve Weisman: Since 2008 there’s been a lot of criticism across the Atlantic with Americans accusing Europeans of ignoring the depths of the problem and vice versa on both fiscal and monetary issues. And related to both is the issue of rescuing creditors and bondholders and banks themselves. Today it seems that after criticizing the United States for quantitative easing, the European Central Bank and the European governments are pumping assistance into the banking system that may somewhat [have] the same effect. Are there tensions between the leadership of the United States on one hand and of Europe on the other?

Nicolas Véron: Well, there are many questions in your question, of course. I think that just at the moment of Lehman and AIG and Fortis it could seem to a certain extent that there was a similar set of problems to address on both sides of the Atlantic in stability in the banking system, disruption of the economy, the risk of a massive rise in unemployment. Now it seems that the United States and Europe have a very different set of problems. Unemployment has risen a lot in the United States. That’s not the case in Europe in general. Conversely the eurozone has this problem of having one currency with many countries in what, I’m afraid, is now a dysfunctional policy decision-making framework, and the United States doesn’t have this problem. So basically I wouldn’t say that there are necessarily fundamental differences of philosophy between the United States and Europe, but they’re addressing problems [that] have ceased being broadly comparable. So they are on different tracks in terms of policy thinking because their minds are concentrated on different things. And this is, of course, an environment [that] can easily be conducive to mutual misunderstanding and finger-pointing.

Steve Weisman: But the finger-pointing seems to have subsided.

Nicolas Véron: I think that the US authorities at this point are very concerned with the situation in Europe, and they don’t want to—

Steve Weisman: Aggravate it.

Nicolas Véron: To aggravate it by basically blaming the Europeans even if, as one can suppose, they feel that the Europeans are not doing their best to address the situation.

Steve Weisman: At the same time, the European criticism of quantitative easing seems to have subsided.

Nicolas Véron: Yes, but that’s because the euro has fallen compared to the dollar compared with the level two months ago. So basically the European concern was that QE2 [quantitative easing II] was a plot to devalue the dollar, and that’s not what is happening because of the difficulties in the euro. So in the very short term basis this of course mutes the criticism. I don't think there has been any fundamental meeting of minds on QE2, just that the direction, the trend of the exchange rate parity has reversed.

Steve Weisman: How long is it going to take Europe to overcome this dysfunctional moment?
Nicolas Véron: I think that until probably relatively recently it was possible to say, “Well, Europe in the end will muddle through.” And basically by strengthening the banking system, making structural reforms and fiscal reconsolidation in periphery countries, and perhaps a bit more expansionary policy in Germany they can overcome this set of difficulties. I’m not sure this is still the case. I think that partly because of a number of policy blunders, the most important of which in my perspective is the inability to properly restructure the banking system, the Europeans are more and more going to be faced with a much more drastic alternative between, on the one hand, the unraveling of the euro, which would be a complete disaster for the European Union from both an economic and political perspective, and on the other hand, more radical changes than were even recently considered realistic to the euro area policy framework. And here clearly is the recent proposal of the Eurobond by Finance Minister Tremonti of Italy and Prime Minister Juncker of Luxembourg taking center stage. I think most reasonable people could, until recently, say, “Well, actually, it will be neither the euro unraveling nor fiscal federalism, but something in between, which will be very much muddling through.” But there has been so little ability to skillfully muddle through in the past few months that I think that the sort of third way is getting narrower and narrower.

Steve Weisman: Thank you, Nicolas.

Nicolas Véron: Thanks so much to you Steve for having me today.