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The real victor in Brussels was Merkel



By Wolfgang Münchau

Mario Monti faced down the German chancellor and won the battle. He will survive a few more weeks or months in politics. It was clever of him to threaten a veto on something Angela Merkel badly needed. He had her in the corner. It was an example of classic EU diplomacy.

But this was only the foreground spectacle. If you look behind the curtain, you will find that, for Italy at least, nothing has changed at all. The European Stability Mechanism was already able to purchase Italian bonds in the open market. The instrument was there, but not used. The agreed changes are subtle. Italy must still sign a memorandum of understanding, and subject itself to the troika – the International Monetary Fund, the European Central Bank and the European Commission. The procedure will be less invasive, more face-saving. But there will still be a procedure.

The real constraint for ESM bond purchases had less to do with the rules than with the overall size limit of the ESM. It has a lending capacity of €500bn – and that has not changed. No matter how you twist and turn it, the ESM is simply not big enough. It will inject equity into Spanish banks. It will need to refinance the programme for Greece, Ireland, and Portugal. It will soon have to cope with Cyprus and, who knows, maybe Slovenia as well. A full-scale programme for Spain still looks likely. I cannot see how you can fit Spain under the umbrella, plus Italian bond purchases.

One of the lessons from the history of financial crises is that bazookas must be big to be effective. This one is not. Nor was the now defunct securities markets programme of the ECB. It did not stem the crisis because the ECB's commitment was strictly limited – and contested by members of its governing council. The ECB still spent more than €200bn on this programme, and yet it did not work. The ESM's budget for bond purchases will probably be lower.

Mr Monti may have secured the right kind of deal politically but to solve the ESM's size problem he really should have insisted on a banking licence. With that, the ESM could have leveraged its lending ceiling to a more realistic level. It will not be able to do this now.

This is why I believe the real winner of last week's summit was not Mr Monti but Ms Merkel after all. She managed to keep Germany's liabilities unchanged. Someone will have to explain to me how we can have no change to Germany's overall liabilities, nor of ECB policies, and yet Italy and Spain can now be safe when they were not safe a week ago.

The deal on Spain was marginally better – on paper. But it, too, is not what it seems. I see three obstacles:

1. A mandate to inject equity into the banks will be conditional on a political agreement for joint banking supervision. This is where Ms Merkel can still exact her revenge. Do not expect this to proceed easily. A joint system of banking would be a very big deal, and I doubt that a sensible agreement can be agreed by October.
2. Direct bank recapitalisations may require a change in the ESM treaty. I know this point is disputed. EU officials say they can do it by diktat. But I cannot see how one can conceivably let the ESM inject equity into banks directly when the treaty says specifically that the ESM lends money to member states for that purpose. Would the treaty not have mentioned this important detail? The head of the Bundestag's budget committee also seems to think that a treaty change is now needed.
3. The new facility is still constrained by the same overall funding limits of the ESM as the bond purchases. I believe the Spanish banks will ultimately need a lot more than the €100bn earmarked for this programme once you take into account the effects of both the housing crash and the depression. The ESM is seriously overloaded.

The most important event last week was probably not the agreement at the summit anyway, but the statement by Ms Merkel that there will be no eurozone bonds “for as long as I live”. My belief is that this statement reveals she is not serious about political union, to which she has been paying lip-service over the past few weeks. Her tactics remind me of the “coronation theory” of the 1980s: the Bundesbank used to say that monetary union was acceptable but only after full political union was completed. It was another way of saying never. I always suspected all this talk about long-term solutions might be a ruse. Now, it seems, we know.

If Ms Merkel is right and there are no eurozone bonds in her lifetime, the eurozone will not survive. Without eurozone bonds or a change in ECB policy, Italy's and Spain's debt – and eurozone membership – is not sustainable. That was as true on Wednesday as it is today.

munchau@eurointelligence.com

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