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The Eurozone crisis: What needs to be done

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The Eurozone crisis is tearing Europe apart. This column argues that Eurozone leaders must (i) agree to create European-level institutions to monitor national budget and banking policies and (ii) draw a line between solvent and insolvent Eurozone nations before the markets do it for them. It adds that we are now discovering that a loss of sovereignty became inevitable the day we decided to create the single currency.

The financial crisis that is tearing Europe apart is caused in part by a misperception – the idea that financial market discipline can be relied upon to induce countries to balance their budgets. According to this leitmotiv, if a country were not forced to preserve the confidence of the markets, its incentives would be distorted; moral hazard would induce excessive debt accumulation.

This idea, which is certainly valid for private institutions, cannot be applied to the Eurozone countries. As long as this idea persists, it will be difficult to overcome the crisis.

Why the idea is wrong

The reason why the idea is wrong has been illustrated in Italy in the past few days. In one week the marginal cost of public debt rose by about one percentage point. A few more weeks down this road at this pace and Italy will be out of the market. The average maturity of the public debt, more than seven years long, serves as a shelter for some time. In the long run however, Italy would be unable to sustain its debt. Not because the Italian situation has worsened in the last six months, just because the markets have suddenly lost confidence.

More generally, we know how financial-markets discipline works. For years problems pile up and are ignored. Then, suddenly, the situation appears unsustainable, and everyone runs for cover. The problem is worsened by the separation of monetary and fiscal policy, a founding principle of the Eurozone. Without the safety valve offered by monetary policy, the contagion from Greece to other countries is a risk that markets cannot ignore. This very fear however, makes the contagion a self-fulfilling prophecy.

To get out of this trap we need deep changes to the institutions on which the common currency is built.

New European institutions are the only solution

If markets cannot do it, the European Commission must act as the intransigent guardian of public finances and budgetary discipline.

- The first step is to drastically strengthen the EU control mechanisms over national decisions in matters of economic policy.

However, control over public finances in not enough, as Ireland and Spain have taught us.

- EU institutions should also have the right tools to prevent the accumulation of excessive debt in the national banking systems.

All of this requires a substantial transfer of economic sovereignty from EU countries to EU authorities (either the Commission or regulatory agencies). The imminent stress tests for European banks will be the first occasion to assess the willingness to really move in this direction. However, it will be necessary to go beyond the stress tests, and strengthen the prerogatives of the newborn European Banking Authority. Clearly this transfer of sovereignty must involve all countries, France and Germany included, not only the so-called “European periphery”.

We must draw the solvency line now

The second step is urgent. Some Eurozone countries are able to honour their debt; some are not. It is necessary to draw a line and decide on which side each country stands. This line, however, should be drawn by European authorities in a deliberative fashion. If it is not done this way, it will be done by the collective psychology of the markets.

- If a country is considered solvent, its debt must be sheltered from contagion.

Highly indebted countries will hardly survive the collapse of confidence which is spreading through the financial markets without protection from Europe as they no longer have their own monetary policy to fall back on. These debts exist and cannot be reabsorbed overnight. Reality, although unpleasant, cannot be ignored.

This goal can be reached in one of two ways:

- The simplest option from an economic point of view (though perhaps inconsistent with the European Treaty) is to give the ECB the mandate to

intervene aggressively and with no constraints to purchase the public debt of the countries under attack.
- Alternatively, and probably with no need to change the Treaty, the European Financial Stability Facility (EFSF) could be instructed to play this role without any prior political approval.

In the latter case, however, the EFSF should have access to market financing with joint guarantees by all Eurozone countries, or should receive financial assistance from the ECB, with practically unlimited resources.

These are the only two ways of credibly and robustly restoring market confidence. Commitments of insufficient size or subject to political verification would be unconvincing and hence ineffective.

Countries judged as unable to meet their debt obligations

If the debt is unsustainable, it must be restructured, and the sooner this is done the better.

The so-called Brady Plan – a mechanism that was successfully implemented in Latin America in the ‘80s – can be adapted to the European situation. At that time the US provided guarantees on the residual share of debt that had to be reimbursed after the restructuring. In Europe this role should be played by the EFSF, so ultimately by the countries of the Eurozone. Inevitably, the issue of recapitalisation of the banks involved should be addressed together with debt restructuring.

The transfer union critique

A common criticism to this type of proposals is that this would transform Eurozone into a “transfer union”, something politically unfeasible. This criticism is misleading.

- If we accept a strong transfer of economic sovereignty from the national level to the European level, the risk of actually being called to reimburse the debt issued by the EFSF (or to cover the losses of the ECB) is minimal.

And even if this were to happen, it would be due to mistakes of the European authorities, not to those of individual countries.

The bargain, in other words, is mutual guarantees and solidarity between member states, in exchange for the creations of a strong European economic government.

Sovereignty transfer was an inevitable implication of the euro's creation

The real objection to this plan is not that it would lead to unacceptable transfers between sovereign states. It is that it would entail giving up some important aspects of national economic sovereignty. But, as we are now discovering, this became inevitable on the day we decided to create the single currency.

Finally, the issue of the mandate of the ECB should be addressed openly. Today, European monetary policy, rather than being helpful, is part of the problem. The ECB is gradually raising interest rates with the excuse of fighting inflation, as if the financial crisis affected another part of the world. But a slight increase in inflation today would be a blessing rather than a danger, as it would contribute to reduce the debt burden. Moreover, a monetary policy less expansionary than in other countries is leading to an appreciation of the exchange rate. If the euro was close to parity with the dollar, maybe also the problems of stagnation of a relevant part of Europe would be less severe, and it would be easier to restore market confidence.

Conclusion

No one can doubt that the sovereign debt crisis in the Eurozone has become systemic. The crisis no longer involves a single country. The very foundations of the Economic and Monetary Union are being shaken. These foundations must be modified in order to survive, and this must be done now, not in a few years.

The piecemeal approach followed so far will not restore trust. European countries must be ready to accept a greater integration of economic policy. They must abandon some wrong ideas.

Topics: EU institutions, Financial markets, Global crisis
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