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How to Contain Debt Crisis in Europe

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With Italy now paying the same rates as Spain to finance its debt, the European crisis has reached a critical stage.

To prevent the possible demise of the single currency, the European Union now must come up with a credible plan to address the future of the euro area. Only a proposal that takes into account the following four painful realities would be credible and stand a chance of persuading markets to resume financing on a sustainable basis.

First, the EU must acknowledge that some countries won't repay their debts and that default is inevitable. The first in line surely is Greece, but that default in isolation would be easily managed because the money involved is modest. But once Greece defaults other countries will be tempted to follow in its footsteps. Even a rescue of Greece, Ireland and Portugal is affordable, but there could be no realistic way of preventing Spain from taking the same course.

Second, Europe's banks are at risk because they own substantial amounts of government debt. As defaults approach, the banking systems across the continent could be subject to an epic run, as depositors and institutions pull out of banks to avoid losses. The European financial system is bank-centered: A run would cripple credit flows, plunging the euro zone into recession and creating a global financial crisis.

No Blanket Guarantee

Third, a program that guarantees the debt of all the countries now at risk (Greece, Ireland, Portugal, Spain and Italy) isn't feasible. Even if Germany, France and the others wished to offer a blanket guarantee, the amounts involved (approaching 3 trillion euros or about $4.2 trillion) would compromise their credit ratings. With Italy and Spain in play, a full guarantee isn't an option.

Finally, any rescue must be accompanied by steps to restore growth, because debts stand no chance of being repaid without economic expansion. Aside from Ireland, the other four at-risk countries face chronic problems. Italy's per capita gross domestic product is lower today than it was 12 years ago. If these countries don't start growing again, even a large haircut on the existing debt won't prevent the problems from re-emerging in a decade.

Europe is in a mess because its leaders have ignored these constraints. This is why the many plans they have drawn up in the past two years have failed to convince markets.

Unfortunately, given these four realities, there are no easy ways out. So the following proposal must be viewed as the least bad of the existing alternatives.

Strengthening Banks

Our plan starts by recognizing that it is critical to forestall a bank run. Thus, any rescue strategy must be concentrated on making the banks strong enough to withstand a sovereign default. The stress tests conducted in the U.S. in the spring of 2009 offer a model.

The strong countries in Europe should pool their money and expand the European Financial Stability Fund to the point where it can backstop the banks against all losses from potential defaults. The scale must be sufficient to cover not only the direct losses on the banks' government bond holdings, but also any subsequent losses that the banks incur from having written insurance against a government default. The total amount required will exceed 1 trillion euros, but the exact number won't be known unless the stress tests of last week are redone to come up with realistic estimates under a scenario in which all five countries partially default on their government debt.

Conditional Support

The stability fund's support to the banks must come with three conditions. First, each of the major banks should be given an estimate of the true amount of additional capital it needs. The banks should then be given a window, possibly six months, during which they are required to raise the capital from private markets. Credible stress tests will eliminate the major obstacle that today keeps private investors away from the banks. The existing shareholders may complain that bringing in fresh capital will greatly dilute their positions. But the truth is many banks are near insolvency anyway, and any griping by investors should be heard with that in mind.

Second, the stability fund's financial support should be available for all major banks and given to those that fail to raise enough capital on the market. This money would be put in as preferred convertible shares with a high dividend rate. If the stability fund injects capital, management will be replaced. These conditions create strong incentive for the banks to find private investors. After the U.S. stress tests, all the banks found private financing rather than drawing on the backstop offered by the government. The stability fund's guarantee should be in place from the onset (subject to the caveat below) to prevent a run if a default were to happen before the banks had raised enough private capital.

Plan for Growth

Finally, as a condition for banks to receive the support, their national governments would have to lay out a credible plan for growth. Critical elements of such a blueprint would be measures to deregulate labor, goods and service markets. Governments would have six months to enact legislation, corresponding to the period before the stability fund's money is converted into shares.

This conditionality is probably the most difficult aspect of our proposal. But we have ample evidence that defaults or devaluations can't fix competitiveness problems that are holding back growth. Markets understand this very well, as was demonstrated last week by their lukewarm reaction to Italy's additional budget, which consists of tax increases and some small spending cuts, but includes no deregulation designed to promote growth.

Legislative Caveat

What happens if, for instance, Italy refuses or is unable to adopt pro-growth legislation? Private investors will stay away from Italian banks. And so will the stability fund, whose guarantee is conditional on the legislation being adopted. The money the stability fund doesn't spend on Italian banks will be redeployed to shore up banks elsewhere. In this scenario, Italy will default, its banks will go bust and the country will have a recession. But now the stability fund can provide a firewall: The costs of saving non-Italian banks -- in France, for example -- from an Italian default will be lower than the price of saving the Italian banks.

This plan would be unpopular in Germany and in the other stronger economies that would be the main contributors to the stability fund. A selling point would be that unlike the plans put forward so far, the taxpayers of contributor nations would be protected by collateral. If things go badly, the stability fund would effectively own the banking systems in the countries that don't come up with a private solution. These assets would have value because they would be limited to those countries that are poised for growth.