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Fighting the Eurozone’s infectious disease

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The Irish bailout failed to stem contagion in the Eurozone. This column argues that the root cause was the separation of monetary policy (ECB) and fiscal policy (member states). If European authorities are unwilling to suspend this separation, the contagion will spread.

The illusions evaporated last weekend. No one believes that fixing Ireland can prevent the “infection” from reaching Portugal and Spain. No one has convincing answers on how to stop the contagion. Uncertainty is paralysing markets and accelerating the crisis’s spread.

Before designing new policies to stop the contagion, it is necessary to review the deep fundamentals that explain the Eurozone’s situation. Each country has its problems which are somewhat different from those of its neighbours. But behind this second fall of the euro lie two common problems. The first and most fundamental is the separation between fiscal and monetary policy.

When monetary and fiscal policy are separate

The experience of developing countries has taught us that when a sovereign debtor cannot borrow in its currency, its position is much more fragile (Hausmann and Panizza 2010). A state that issues debt in its own currency may end up with a public debt well over 100% of national income without causing financial instability. Countries that get into debt in foreign currencies typically have to stop first. The 2001 crisis in Argentina, for example, erupted when the public debt had reached 63% of national income.

When debt is denominated in foreign currency the central bank cannot help if the markets refuse to renew maturing debt. Printing money is useless as it leads to a devaluation of the debt burden. The awareness that this safety valve is missing exposes the sovereign debtor to the volatility of financial markets. As long as the markets have confidence, the debt is sustainable and there are no problems. But if trust is lacking, there is nothing to be done. The weight of the maturing debt can quickly become untenable. In other words, the central bank is a fundamental pillar on which rests the stability of a sovereign debtor. Under normal conditions we may not be aware of this. But the implicit assurance that we can count on the central bank under extreme conditions is what makes the system stable.

Eurozone countries can borrow in their own currency. However, no single country can rely on monetary policy to deal with emergency situations. The inevitable consequence is that confidence crises in sovereign debt are more likely and may even involve countries that have not reached very high debt ratios such as Spain and Portugal. We had the illusion we could ignore this problem. Now we know we can't.

The second problem common to several European countries is the intertwining of public debt and banking crises.

Public debt and banking debt

As has often been noted (Manasse and Trigilia 2010), the Greek and Irish cases are quite different in their origins. In Greece the government is at the origin of the recent crisis. In Ireland the government budget was under control until very recently (in 2007 the net public debt of Ireland was 12% of GDP). It is private debt that tumbled out of control.

During the summer of 2009, two events turned the situation around. Supervisors noticed (too late) that bank losses were much higher than expected. The situation became pressing as the guarantees the Irish government extended at the height of the crisis of 2008 were running out. The government chose to renew the warranty on senior bank debt, amounting to more than 30% of GDP. But this was too much for public finances already under pressure from the economic crisis. The markets have lost confidence in Ireland. The lesson is simple. There is no benefit from saving banks if it puts the solvency of the sovereign at risk.

Spain will also be infected, as it is facing a similar problem. Spanish public debt issues in 2011 are estimated at €90 billion, to which one has to add a similar amount of bank bonds maturing. Spain also had a huge housing bubble. The bad loans of Spanish banks have so far been contained, thanks to banking supervision much more severe than in Ireland. But in the balance sheets of savings banks (the Cajas) many problems still lurk. In addition, Spanish banks are highly exposed to Portugal. The Spanish Government soon might have to find a way to keep the banking system afloat without sinking the public accounts.

Solutions

To stop the contagion one should move in two directions.

- First, it is necessary to isolate the problems in the banking sector and tackle them with determination.

This means first of all to recognise losses or situations at risk in banks' balance sheets. But, as we saw in Ireland, sometimes the state budget is unable to absorb all losses.

For this reason, it may be necessary to force the creditors and shareholders of the banks to bear losses, safeguarding deposits. Governments cannot guarantee all the so-called 'senior bonds' of banks.

- Second, it is essential to enlist the help of EU institutions to give banks and sovereign debtors the liquidity that the markets will surely withdraw at times of uncertainty.

Since banks are financed primarily with short-term debt, their demand for liquidity is huge. For example, the Spanish banking system alone has raised hundreds of billions on money markets. Only the ECB may have the strength to offer this liquidity if the markets refuse to provide it. The ECB can do this if it has the assurance that the banks are sound. This is the task of supervisory authorities who, however, have failed miserably on quite a few occasions. Only in July, the Committee of European Supervisors concluded that only 7 out of 91 European banks did not pass the so-called stress tests.

What about the sovereign debtors? In principle they should apply to the European Financial Stability Facility, the fund established in May which may deliver up to €440 billion to help the Eurozone countries. However, these resources may be insufficient. The Facility will last only three years, and we do not know what will replace it.

The alternative is for the ECB to buy government debt in the secondary markets to support its market price, as has already been done (although only temporarily) to mitigate the effects of the crisis in Greece. In a situation of systemic crisis, market confidence can be regained only if there is an assurance that the central bank is prepared to support the government bonds of a country under attack.

There is no doubt that this has become a systemic crisis and no longer the problem of one or two countries. This means we must suspend the separation of fiscal and monetary policy, one of the pillars on which the European Monetary Union was built. If European authorities are not willing to take this step, the contagion will spread.

Editor's note: A version of this article first appeared in Il Sole 24 Ore.

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