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European Vertigo

Remedying the Eurozone Crisis

By Fredrik Erixon

Briefing Note for the European Summit
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Introduction

It is crunch time for the Eurozone.

Political leaders in Europe have set another deadline this week to "save the euro". This time they have promised to deliver the crisis measures and reforms necessary to prevent the crisis from breaking the neck of the euro cooperation. One thing should be clear: Eurozone leaders are going to fail on that promise. This week's summit, and other steps taken this week, is almost certainly not going to be the final point in the Eurozone's quest for an adequate policy to fight its crisis. Suggestions from key leaders and officials that this summit actually will – no doubt done in the good-natured belief that they will help to concentrate political minds – only confirm to markets and electorates that the Eurozone's complicated political structure, and the poor conditions for effective crisis communication it ensues, is badly suited to manage a crisis of this proportion.

However, it is much more likely now, than at any earlier point during this crisis, that leaders will lay the ground for a crisis policy that holds the potential to regain some of the lost credibility in the Eurozone and its leaders capability to address its problems. Yet it will take time for such a policy to unfold. While time is a currency that the Eurozone has almost run out of, it still is possible to avoid a collapse of the currency union. But that would require extraordinary action by Eurozone leaders.

A proper crisis plan now has to start by acknowledging the fact that the crisis is systemic and *concerns the institutional inability of the Eurozone and its leaders to understand the severity of the crisis and to act upon that understanding*. While the assumption since the late 2009 has been that this is a crisis of sovereign debt in some peripheral countries – triggered either by fiscal irresponsibility over a long time or acute action during the financial crisis in 2008-9 to save over-leveraged banks in economies with housing bubbles – it has now become *a crisis of the sovereign*. To put it differently, this is a crisis of the state and the authority of state institutions.

At the heart of it is the widespread disbelief in the Eurozone's capacity to manage times of severe economic and financial distress. Attempts to address the crisis at past summits have not only failed but, more worryingly, amplified this disbelief and pushed the Eurozone deeper into the crisis. Not only have these summits revealed leaders to have a poor understanding of the scale, and the nature, of the crisis. These meetings have also demonstrated that there are clear political and legislative limits to what Eurozone members are prepared to do in order to save the euro.

The institutions that have been set up to manage the crisis – especially the bailout fund, the EFSF – were poorly constructed from the start. Now the EFSF has lost its authority because markets rightly distrust the capacity of Eurozone leaders to back up this fund by necessary legislative and political action. Eurozone leaders like Chancellor Merkel and President Sarkozy have repeatedly

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pledged to do whatever is necessary to defend the euro. Few, if anyone, would challenge the desire of these leaders to defend the euro. Yet an increasing number of people have come to mistrust their authority to do so, especially people who are asked to risk money on the assumption that these leaders will successfully manage the crisis and that the euro will survive in its current form.

When the EFSF was forced to cancel its bond sales in early November the wheel was starting to come full circle. The bailout fund targeted to borrow money in the name of less credit-worthy countries could no longer raise necessary funds at acceptable rates. The warning from Standard & Poor's about the risk of a downgrade is not surprising at all. So the strategy to expand the bailout fund through leveraging the base guarantees has worsened the distrust in Eurozone's leaders to command authority in its crisis policy. It did nothing but putting fuel on the fire. Eurozone leaders had already declared that they are not going to expand the guarantees, partly because they fear popular revolts at home. They have also declared that there are clear no-go zones in Europe's crisis-fighting armory. Eurobonds, systems for direct fiscal transfers (not loans) between member states, or a European Central Bank with an explicit mandate to use monetary policy to backstop developments on the bond markets that run the risk of taking the entire Eurozone down (sometimes referred to as lender-of-last-resort mechanisms) have all been ruled out.

Even if there are good arguments to reject such policies, they have served to demonstrate that Eurozone leaders are clearly not prepared to do what it takes to save the euro. Political leaders may be frustrated, and electorates may be exhausted by constant calls on them to go along with an endless stream of crisis packages, but what has made this a systemic crisis is the institutional inability of the Eurozone to manage a grand crisis rather than the fundamental economic and fiscal problems in Europe's distressed economies.

This inability has also been a key feature of many financial crises and sovereign defaults in recent decades; markets have grown increasingly skeptic to the institutional and political ability to address core problems and at some point trust has completely vanished. In the Eurozone's crisis a central problem has been the remarkably poor management of the crisis in Greece; a deep structural economic and fiscal crisis in an economy representing a tiny fraction of the entire Eurozone economy has metamorphosed into a systemic crisis because of the way Eurozone leaders approached the crisis in Greece.

In the countries that did manage to get out of the initial crisis in 2008-9 – like the Baltic countries – a central element of crisis policy was to maintain trust in the political system's capacity to address the core problems. It is true that the Baltic economies are different than, say, Greece and Italy in that their capacity to grow out of a crisis is better. Yet the Baltic economies would not have achieved their stabilization unless markets kept their trust in the political and institutional capacity of these countries to take necessary measures.

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What needs to happen now?

What will Eurozone leaders have to achieve at this week's summit to regain its lost confidence and establish policies that can avoid a breakup of the Eurozone? Essentially, Eurozone leaders now have to prepare the necessary conditions for the ECB and other countries, through the International Monetary Fund, to take a much greater role in the crisis by intervening on the bond markets and by ring-fencing key economies. The time for addressing the crisis by own fiscal and financial measures by governments is over. That alone is no longer going to help. Such measures are still necessary, but primarily because they are conditions set by other institutions o intervene. In other words, now is the time for the Eurozone to put on the best dress and makeup in order to court the ECB and he IMF.

One of the confusing debates in the Eurozone during the past year has concerned the ECB and its role as a backstop. The source of the confusion has of course been the Treaty and the explicit prohibition to directly supply governments with deficit funding. The key role played by some German officials have amplified the impression that the ECB is constitutionally constrained to act. Yet that presumption has been disproved in the past years since a solid majority in the ECB has repeatedly voted for extraordinary measures that in effect assist distressed economies by taking down their bond yields. It is years now since the ECB passed the limit to what people of the Bundesbank school of thought could accept.

Arguably, the issue now is not so much whether the ECB can assume a much greater role in calming bond markets. It clearly can. The issue is rather whether it has necessary political cover to do so. And that cover is not Eurozone leaders' calls on the ECB to act. On the contrary, such calls are contra-productive as the ECB can only act if it is seen to do so independently. The cover is rather about Eurozone leaders taking sufficient fiscal and political actions to reduce their own roles in causing market turbulence. The ECB cannot correct systemic errors by politicians, but it can in effect act temporarily to bring down bond yields at a time when fiscal and economic policy no longer is a key reason to why normal monetary policy will not have intended effects.

Essentially, the same logic applies to any greater role for the IMF in the Eurozone's crisis. It will be close to impossible to persuade other world economies to assist Europe through the IMF if the European vertigo continues to be a chief reason for the crisis spreading to other economies in Europe. A Eurozone that takes decisive actions, however, is much better suited to receive outside help.

So what will Eurozone leaders have to do now in order to court the ECB and the IMF?

Clarify and improve the October deal

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Firstly the Eurozone has to correct some of its past mistakes. The crisis deal agreed at the October summit is a first area in need of improvement.

- Clarifications on the scale and consequences of private sector involvement in cutting Greece's public debt are necessary. There are still too many unanswered questions about the haircut that will be forced upon private holders of Greek public debt as well as its consequences for especially Greek banks. The metric for that haircut and the resources needed to avoid bank collapses in Greece should be clarified.

- The Eurozone must stop its nonsense over bank recapitalisation and be honest about the scale of the problems in the European banking system and the consequences of various ways to address problems of solvency as well as liquidity for banks. There are various ways to approach problems related to solvency and short-term funding for banks. One way that should be avoided is to effectively force banks to generally depress credit. Banks that are clearly insolvent should be addressed separately by policies specifically designed to clean them up and make them solvent again. Banks that have funding problems, or that approaches capital-adequacy limits because of the general adverse market conditions, need a different set of policies. If they are forced to rapid recapitalisation, many of them will do so by depressing credit rather than increasing its capital position.

- Finally, the Eurozone must get real on the size of the EFSF. It simply cannot leverage up the bailout fund and use that as a tool to ring-fence Italy and other distressed economies. This political charade must end. A bailout mechanism like the ESM can work as a tool to deal with bailouts to smaller economies like Greece, Portugal and Ireland. But that is the limit to what it can achieve. Consequently, it is time to end the dream of creating a giant European Monetary Fund with the capacity to bankroll many and big economies. There simply is not a readiness in key member states to put up the money necessary to create such a fund. This is also why recent suggestions to combine the EFSF and the ESM are likely to hit the buffer of political reality. An ESM still need the capital to start operation, and there are not many governments in Europe now with the capital available to create a new fund.

Stronger reform commitments by Italy

Italy has recently taken steps forward to stabilize its fiscal position. That is fine. But it is not the key ingredient to reestablish trust in Italy's capacity to manage its own public debt without outside assistance. The key ingredient is rather to push through structural reforms to increase productivity and growth in Italy. Without a higher trend growth in Italy, it will be impossible to stabilize its public debt.

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Italy is not the only country in this position: underperforming growth is the problem in many of the distressed economies. So anemic economic growth is at the centre of current Eurozone woes. Markets were clearly fooled in the past decade by the idea that Greece, Italy and Portugal could take up loans at the same rates as Germany despite sharp differences in performance and risk. Yet another pipe dream, nurtured by many governments, was the phantasy that they could continue to expand public spending while productivity and growth slowed down. The problem in several countries in or at the risk of default today is not stupendously high public debt, but profound economic underperformance illustrated by low productivity growth and economic growth. The Eurozone crisis is as much about underperforming economies as high debt levels.

It should come as no surprise that the three EU-15 economies with lowest pre-crisis productivity were Portugal, Greece and Italy. Greece and Italy are also the two economies with the lowest employment rate. Furthermore, Spain, Greece, Italy and Portugal are the countries that have seen their unit labour costs, a measure of competitiveness, rise at the fastest pace during the last decade. Exactly the same countries were also topping the league of EU countries with the biggest current account deficits in that period.

Italy is far more important than the other economies in terms of creating trust in the Eurozone now. In addition to recent fiscal reform proposals, Italy should henceforth deliver far more radical proposals than hitherto to reform its economy. If Italy fails to do so, other measures to stave off spiraling bond yields in Italy will not suffice.

A new deal for Greece

Even if it is not critical for this summit, Eurozone leaders will soon have to design a new package to deal with the depression in Greece. Greece is now in a vicious cycle: new austerity packages only enforce the economic contraction, and continued contraction forces Greece to come up with new austerity measures to fulfill its commitment to budget balance in a few years time. If this continues, Greece will soon have to leave the Eurozone.

A new package to save Greece should build on three components:

First, the conditions imposed on Greece in exchange for financial assistance should focus entirely on structural economic reforms and not on medium-term budget balance. Financial assistance to Greece will be needed for a long time. Consequently, the target should not be budget balance in a few years time, but in 2020. To achieve that, the economic contraction in Greece must stop and the country needs to return to growth. In the medium-term, the only way for the economy to recover and for growth to be sustained is to increase the productivity and competitiveness of the Greek economy. Hence, the entire focus should now be on growth-enhancing reforms.

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Second, Greece's public debt is unsustainable and will remain so despite the debt restructuring agreed in late October. Inevitably there will have to be another effort to cut Greece's debt – and this time the effective rate of the debt has to come down to the regions of 75 percent of GDP. This cannot be achieved without pushing the limits of what some banks can muster. Consequently, there will have to be a special package for those banks to survive. Furthermore, such a cut cannot be achieved without senior debt held by foreign public bodies to be restructured. Balance sheets of some central banks will be affected. Again, there will have to a special package to recapitalize some of these central banks.

Third, there will have to be a long-term commitment to assist Greece financially. Again, Greece cannot return fully to private capital markets before 2020. If other Eurozone economies are not prepared to do finance Greece for such a long time Greece's problem will need to be addressed in a completely different way. Markets can deal with that, too. But in the absence of a long-term plan for Greece suspicions will remain and eat itself into the Eurozone system as a whole.

A new fiscal compact

The European Union, or the Eurozone, needs to commit to greater fiscal discipline in future and enshrine those commitments in an agreement with real bite – that is, and agreement that effectively will block fiscal irresponsibility in an institutionally and constitutionally orderly manner.

It is true that many of the fiscal reforms adopted at the EU level so far during this crisis have targeted long-term concerns rather than acute problems. Yet there are two compelling reasons for a new fiscal compact.

First, the President of the ECB has explicitly said a fiscal compact is necessary for the ECB to take a greater role on bond markets. One can debate whether that is right or wrong. Now, however, there are not any other alternatives than to acquiesce to the ECB demand.

Second, some governments, including Germany, are coming close to overstepping their constitutional ability to create economic-policy structures for the Eurozone. These countries need to have a clearer treaty structure for Eurozone economic governance to err on the right side of their constitutional constraints to pool sovereignty on fiscal policy matters. If such changes do not occur, there is a risk that a constitutional court may rule that some of the new Eurozone policies to be unconstitutional.

The exact design of a new fiscal compact cannot be decided at this summit. But the principles for such a compact, and the pathway for it, can be agreed now. If it involves changing a treaty, which is likely, the limits of those changes have to be accepted by member states. The way forward is

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not to set up a new intergovernmental convention, but to focus on limited changes that stand a chance to be accepted by all member states, and their electorates, within the foreseeable future.

The role of the IMF

An increased role for the IMF is critical. But the role of the IMF has to be distinct and concern tasks that other world economies are willing to pay for. And that role cannot be to play a junior role in economically suicidal mission in Greece, which is the case today. In fact, it is in the IMF's own interest to part from the role it is currently playing in Greece. Presently, the IMF is in a troika cooperation that triggers distrust in the IMF itself.

A new role for the IMF would be to ring-fence the bigger Eurozone economies. In effect, that is what countries like China and the United States could be reluctantly persuaded to pay for. A crisis in Greece or France would have a devastating effect on the entire world economy. Designing such a role, however, will be complicated. And it is not in the power of the Eurozone to design it at this summit. What the Eurozone can do, however, is to give a much clearer signal of its intent to court the IMF and how Eurozone countries are willing to pay for their own financial contribution to a special mechanism operated by the IMF.

Growth and adjustment

Finally, new initiatives will soon have to be taken to spur competitiveness and growth in Europe. It will not be possible to agree on such a programme at this summit, but initiatives should be proposed in the next few weeks. Three things are critical.

First, many individual governments need to give much greater attention to promoting growth in their adjustment programmes. In the adjustment process ahead of the creation of the Eurozone, too many countries opted for quick fixes in order to make themselves eligible for Eurozone membership. There were too many tax increases that suppressed growth, and too many unsustainable spending cuts. In the adjustment process countries should avoid making the same mistakes. A badly designed adjustment programme can suppress economic growth for the next decade.

Second, it is not possible to create a grand Keynesian compact of discretionary stimulus now in order to help other and distressed economies. There are clear economic limits to such a programme: greater discretionary stimulus in Germany is not likely to have any significant effect on growth in Greece. There are also political limits: individual governments cannot be asked to effectively increase deficits to finance expansion in other economies.

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Third, there will have to be a major change in the EU leadership in pushing growth-enhancing reforms in EU policy. This is conspicuously absent in EU policy today. The EU's flagship programme for competitiveness and growth – the so-called 2020 programme – is grossly inadequate and neglects the key EU reforms that could promote growth.

Now is the time to push for much greater reforms to eliminate barriers to trade and cross-border integration in Europe. A single market for services is critical in such a programme. But many other reforms can be undertaken as well. Bolder leadership from Brussels is a prerequisite for that to be achieved.

Concluding remarks

The Eurozone crisis is not going to end soon. The crisis summit this week cannot deliver the single bullet necessary to avoid a market tsunami that risk breaking the neck of the entire euro cooperation. But Eurozone leaders can take decisive steps and correct their own recent mistakes. Appropriately designed, the package emanating from this summit could set the policies necessary for other institutions to play a much greater role in fighting the crisis and for long-term adjustment processes to work efficiently. The European vertigo has to be remedied. And it can only be remedied by leaders who by their own actions demonstrate that their past behavior is the source of the Eurozone illness.

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