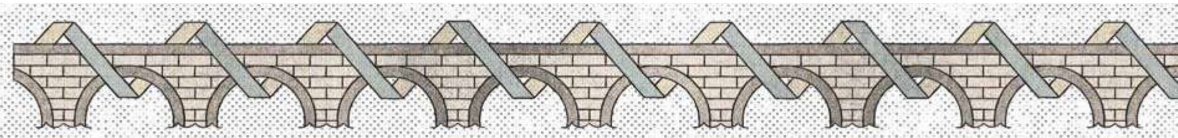


How Europe Is Making Its Crisis Worse

By Francisco Torralba

Fiscal austerity will fail to cure what ails the euro.

It is unfortunate that Greece was the first eurozone member to go bust, for that country's experience has tinted the crisis as one of "fiscal profligacy." Although it is true that the Greek government frittered away public funds and lied for years about its liabilities, Portugal, Ireland, Spain, and Italy all kept their fiscal deficits within prudent ranges before 2008. In fact, their primary balances were, on average, positive between 2001 and 2007 (Exhibit 1). A more accurate assessment of the crisis is that it was caused by the combination of current account imbalances, a fixed exchange-rate regime, and the absence of guarantees against sovereign default. But let's start from the beginning.

Tracing the Origins of the Crisis

The birth of the euro in 1999 meant that Germany locked the exchange rate with its European neighbors. In the following years, Germany's productivity, contained growth of unit labor costs, and a constant exchange rate created a backdrop that was greatly favorable to German exporters. The country's trade surplus ballooned—at the expense of the current account balances of today's troubled economies in Europe's periphery (Exhibit 2).

Giving up national currencies also meant handing over monetary policy to a foreign entity: the European Central Bank. The new bank's only mandate was to maintain price stability for the eurozone as a whole. The interest rates set to achieve that goal, it turns out, were too low for the less-competitive members of the Economic and Monetary Union. Those countries, faced with low interest rates and stiff competition in the tradable-goods sector, had two choices: allow a spurt of debt-fueled spending and real estate development (which Ireland and Spain did) or see their private sectors wither (which Italy and Portugal did). Either way, the ratio of external debt/GDP crept up (Exhibit 3).

Fast-forward to 2008. A financial-crisis-cum-deep-recession engulfed the world. Credit dried up, unemployment soared, tax receipts shrunk, and the welfare bill got heavier. Spain and Ireland had to prop their banks as well. Germany and the other competitive countries sprung back to life in 2010. Their peripheral partners were not as successful, and their public finances deteriorated quickly.

To be sure, inefficient regional economies and low interest rates by themselves would not have produced a sovereign debt crisis. Two additional prongs are needed to explain how things got so bad: the mispricing of sovereign risk and bank regulation (or lack thereof).

After the introduction of the euro and up until 2007, investors assumed that Europe's financial integration meant that all of the union's government bonds were risk-free (Exhibit 4). They should have known better. European Union treaties explicitly forbade bailouts of sovereigns. Plus, the union's fiscal rules quickly proved to be meaningless: In the early 2000s, several countries violated the 3% deficit limits and got no punishment for it.

Banks, of all investors, should have been forced to be more prudent. The ECB bears part of the blame, by discouraging financial institutions from distinguishing between sovereign bonds of different countries and initially accepting all EMU debt as collateral of identical quality. The European Banking Authority did not include sovereign haircuts in the stress tests up until 2010. Before the crisis, a stronger regulator would have forced banks to shore up more capital, in a market environment where it was still possible to do so. Once in the crisis, marking-to-market just feeds the bank run.

Current Situation and Solutions

Because fiscal deficit is the (mis)diagnosed disease, austerity is assumed to be the cure. The European Commission, the IMF, and the ECB—better known as "the troika"—have demanded drastic reductions in public deficits from the countries that have received bailouts: Greece, Ireland, and Portugal. Spain and Italy have gone on pre-emptive diets. European economies, already on shaky footing, are now certain to suffer deep recessions in 2012.

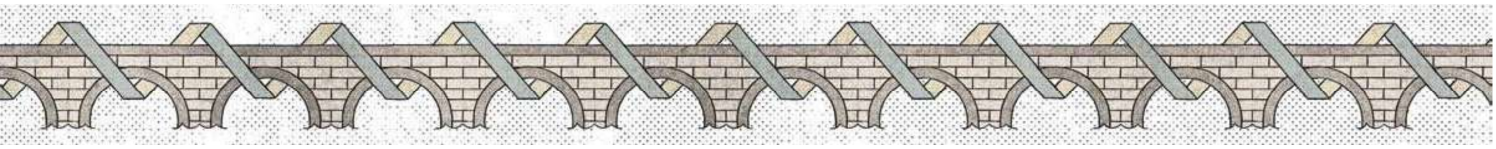
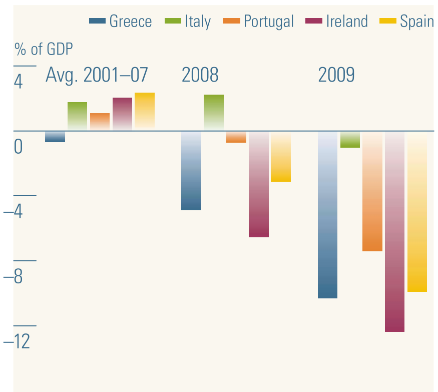


Exhibit 1 Crisis-Damaged Budgets: The fiscal balances of Europe's peripheral countries were healthy until the 2008 global crisis.

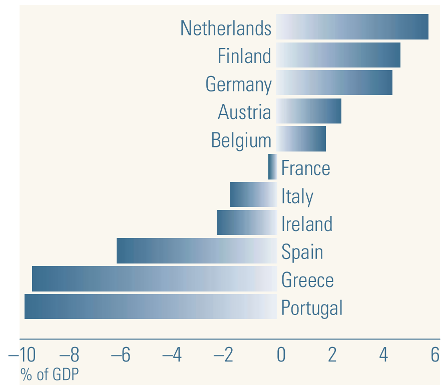
General Government Primary Net Lending



Source: IMF World Economic Outlook (September 2011)

Exhibit 2 Exporters Benefit: The creation of euro was a boon to Europe's core exporting countries at the expense of the periphery.

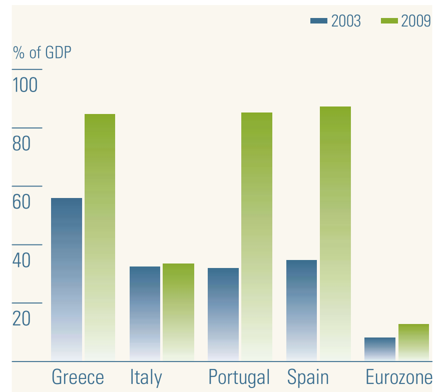
Average Current Account Balance 2001–10



Source: IMF World Economic Outlook (September 2011)

Exhibit 3 Periphery's Debt: Giving up control of their currencies and low interest rates also caused debt levels to rise in the periphery.

Net External Debt, Private and Public



Source: Bank for International Settlements, 2010.

The economic downturn fuels the vicious loop between growth, sovereign debt, and the solvency of banks. As unemployment rises and tax revenues shrink, the deficit grows. The increasing probability of a sovereign default undermines the soundness of banks directly, because banks hold a large share of sovereign debt, and indirectly, because weakness of the sovereigns makes it impossible to rescue the banking sector. As markets question the strength of banks, the wholesale lending market dries up. Deleveraging via balance-sheet shrinkage does not help either. The private sector is thus starved of credit, which in turn reduces consumption, investment, and growth. Unemployment rises, and so on.

It is true that excess debt is an insurmountable problem for Greece and possibly others. Insolvent countries must default. And some measure of fiscal restraint is necessary for everyone. But the long-run issue with the euro is much harder to solve than mere profligacy. The euro project will eventually fail unless two problems are solved.

First, external deficits must be reduced. This requires the Mediterranean members to become more competitive. That process is not easy or quick. If it were, they would have done it already. But it also requires that Germany adopt policies that discourage domestic saving, boost consumption, let its relative unit costs rise, and reduce the external surplus. In a nutshell, Germany must become less German-like. Instead, Germany maintains that current account surpluses are a virtue and imposes the burden of reform on others. Cutting the external deficits of the periphery requires wage deflation. Add to that higher taxes and a dwindling welfare state, and it is easy to envision general strikes, civil unrest, and the rise of populist leaders. Faced with a choice between restored self-determination and membership to a European *Miserable* Union, tired citizens might go for the former. Leaving the eurozone is not a good idea, but Germany's mulish insistence on mercantilism and austerity raises the odds that the project fails.

The eurozone's second must-do is fiscal integration. The EMU needs to add some form of joint liability for national debts. Eurobonds allow countries that run into fiscal trouble to benefit from the strength of the others. In exchange, Germany would demand some control of the national budgets, deficits, and debt issuance to ensure some measure of fiscal discipline. It is a reasonable request, but the member countries are not ready for this loss of national sovereignty. Remember the rejection of a European Constitution in 2005, by none other than France.

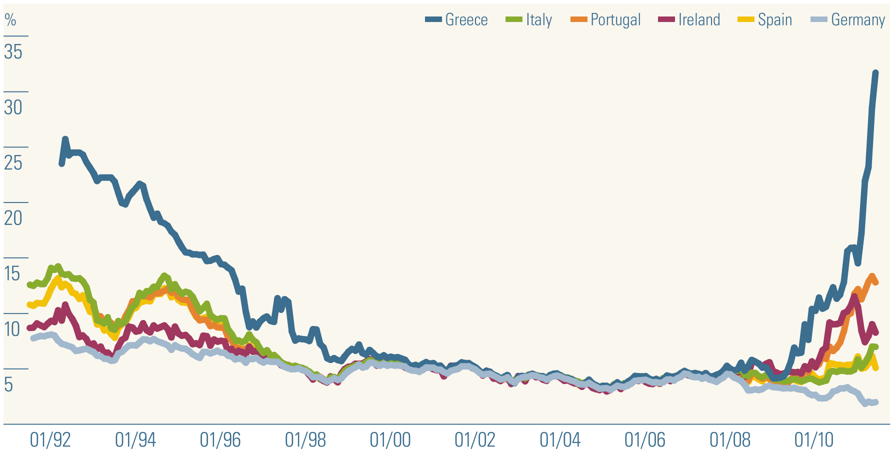
Even if the EMU went ahead with fiscal integration, a fiscal union without economic reform would not work. Under that arrangement, the south would become forever uncompetitive, underemployed, and dependent on fiscal transfers from the north. And to that, the Germans respond with a loud "Nein!"—with good reason.

Alternatively, Europeans can have a monetary union without fiscal union. But if they follow this path, they must accept that sovereigns can default. In that world, bond markets would discipline spendthrift governments, and the ECB would discriminate against dodgy sovereign debt when it lends to banks. Countries with dicey fiscal records would face a higher probability of default, and it would be made explicit that Europe would not come to their rescue.

Dealing with competitiveness, growth, and fiscal union will take years. Right now, the

Exhibit 4 Euro Bonds Were Risk-Free, Until They Weren't: Once trouble hit, the bond yields of individual countries' sovereign debt diverged sharply.

Yield to Maturity of Benchmark 10-Year Bonds



Source: FactSet.

patient needs a defibrillator. The eurozone must immediately stem the loss of confidence in sovereigns and banks alike. The ECB is the only institution that can do that. Should the central bank declare that it commits unlimited funds to supporting sovereign debt, the bond vigilantes would retreat. They cannot fight a bond buyer with an infinite balance sheet.

So far, however, the ECB has doggedly refused to make large purchases of national debt. For one thing, Article 123 of the EU Treaty prohibits the central bank from financing the public sector's obligations. By buying bonds, the hawks in Frankfurt argue, the ECB would risk fueling inflation and losing credibility. By not buying them, I would say, the central bank risks depression and deflation, neither of which fits the bank's mandate.

Alternatively, the ECB may fund sovereigns indirectly, via the banking system. The central bank would lend to banks at cheap interest rates and insist on receiving sovereign debt as collateral, thus supporting demand for such debt and keeping yields low. This way the central bank would not be violating the letter of the law. Banks would remain liquid and would earn the handsome spread between the sovereign yields and the ECB rates to boot.

Unfortunately for banks, this scheme is unlikely. Encouraging banks to turn ECB loans into more purchases of sovereign debt would imply an increase in borrowing beyond their already-high leverage levels. Also, ECB dislikes bond purchases because the central bank would gain de facto control of both the banking system and sovereign finances. Because the wholesale credit market is dry, banks are at the mercy of the ECB. If the central bank asked them to provide, say, Spanish debt as collateral, banks would buy Spanish bonds. If the Spanish government did not address its fiscal issues to the ECB's liking, the central bank would drop Spanish bonds out of its list of preferred debt—by applying a steeper discount on Spanish collateral. Banks would then sell Spanish bonds and invest in whatever the ECB suggested them to buy. Spain would be forced to follow the bank's dictum, or default.

Large-scale purchases of debt do entail risks. Still, in the short term, there is probably no other way to avoid defaults in a context of fiscal austerity, economic recession, and fixed exchange rates. If the ECB does not cave in, it may become a central bank without a currency to manage.

Likely Scenarios

Several disastrous scenarios are possible. Depositors may lose their confidence in banks. Greece (or Portugal or Ireland) might decide to quit the euro—also leading to bank runs. Or austerity might lift a populist, anti-Europe government to power, setting off a cascade of defections from the currency area.

The cost of returning to national currencies seems high. From a legal standpoint, it would be a colossal mess to figure out how to honor euro-denominated contractual obligations. A Frenchman told me: "Once the omelet is made, you can't put the egg yolks back into the shells." The euro project was flawed from the outset, but mending it should bring more benefits, at least in the long run, than quitting it.

Common sense suggests that leaders will avoid a blowup. The most likely outcome, I still believe, is that Europe does just enough, just in time. In the next few months—or is it weeks?— I envision both banks and sovereigns coming perilously close to defaulting. The ECB would finally be forced to keep everybody on life support, with the stated goal of preserving financial stability. The EU would then cobble together enough reforms to please the central bank, although not enough to ensure the long-term economic success of the currency. The euro would be saved, but for how long?

Eurozone countries got themselves in a monetary straitjacket, then failed to develop fiscal institutions that would strengthen the whole and lived the illusion that sharing a currency was the same as sharing a Treasury. There is no time for the eurozone to ease its way into a more integrated pact. The only options are radical monetary intervention, default, or a split-up. M

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