DOI: 10.1007/s10272-010-0355-2

Eight Months Later – Has the Eurozone Been Stabilised or Will EMU Fall Apart?

Eight months ago, as the risk of sovereign default in Greece first emerged, the Intereconomics Forum invited a number of contributors to examine the options available to EU policymakers. As the threats to European Monetary Union resurface now, six of the same authors return in this issue's Forum to reassess the situation, in particular with regard to the EU's recent policy responses to the ongoing crisis. Whereas both optimists and pessimists could support their views with strong arguments eight months ago, the EU's current predicament has shifted the prevailing sentiment strongly toward the pessimistic view. From the Irish bailout to the precarious status of Portugal, not to mention the potentially disastrous situation looming in Spain, our contributors are uncertain whether EU policymakers are up to the challenge of defending the euro. As evidence of this, several point to the EU Council's October decision to establish a permanent crisis resolution mechanism to ensure an orderly state insolvency procedure, which did little to calm markets. Nonetheless, most of these economists still see ways for the EU to escape the crisis without being forced to abandon the common currency.

Wim Kösters

Credible Rules, Not Discretion, Will Make the Euro Sustainable

After the international financial crisis and the succeeding recession, the present problems of the euro area can be considered the third stage of the recent worldwide slump. Since autumn 2009 the yields and the prices of credit default swaps for Greek government bonds and later on also for Irish, Portugese and Spanish ones have increased markedly, showing that international investors have become more hesitant to finance the public deficits and debts of those countries. Growing concerns over a possible state bankruptcy in Greece and a domino effect leading to the default of other southern EMU member states caused a devaluation of the euro *vis-à-vis* the US dollar as well as other currencies in spring 2010.

In response to these developments, the EU council decided in April and May 2010 to set up two rescue packages: €110 bn for Greece and €750 bn for the euro area countries (European Financial Stability Facility, EFSF) limited to three years and subject to strict conditions. The IMF was involved in these decisions and will contribute €30 bn and €250 bn respectively to the packages. It will be part of the monitoring and controlling process accompanying the issuance of loans and will support this process with its know-how. In addition, the European Council announced that the European Central Bank (ECB) will take part in the programme. The ECB then declared that it will take extraordinary measures, i.e. make direct purchases of bonds from over-indebted EMU member states to stabilise financial markets. In explaining its rescue packages to the public, the EU Council said that the measures were necessary to counter the massive attacks of international speculation trying to damage or even destroy the euro and the EMU. It expected that the sheer size of the package would deter further speculation and that the programme would therefore not be drawn on. In general, the wording of the EU Council was military in fashion, speaking of a general mobilisation to fight speculative attacks etc.

As it turns out, this "war cry" was intended to take people's minds off the true causes of the crisis. For some time this was quite successful because the public debate was concerned with how to regulate the financial sector to prevent speculation and how to limit the earnings of bankers and other financial market actors. But after a while the red herring was recognised by many as such and the true reasons for the crisis and necessary reforms were discussed more seriously.

Reasons for the Euro Crisis

What caused the euro crisis was the neglect of the rules of the EMU over many years, mostly by the same actors who had previously agreed upon them in the treaties but now blamed speculative attacks.[1] As it turned out, the rules of the Maastricht Treaty were not really wanted and accepted by all who signed it. Already at the start of the EMU, adherence to the convergency criteria was examined laxly. The main reason for this was to get the EMU started with Germany as soon as possible and thus end the German monetary hegemony. The acceptance of Greece into the EMU in 2001 on the basis of false budget figures, and the fact that it failed to comply with the budget criteria in every single year after its admission without being sanctioned, confirmed that the examination of adherence was too lax. For many years France demanded that the rules be changed toward less price stability orientation and less independence of the ECB but more political discretion. This was advocated most vociferously in the last presidential election campaign by all candidates and thereafter by a forceful move by the newly elected president, Nicolas Sarkozy, which received positive reactions from southern EMU member states. Correspondingly, President Sarkozy was quite satisfied with the agreement reached by the European Council in May 2010. The following day he triumphantly stated that 95 per cent of the decisions were based on French ideas. He claimed that a veritable economic government for the EMU would now be established, compelling all EMU institutions (including the ECB) to fight against speculation without mercy.[2]

It seems that France has got what it has been demanding for many years: less binding rules, less ECB independence and more room for discretionary political action. In my experience, French politicians consider rules to be technocratic in a pejorative sense, whereas only discretionary action is considered to be true policy. Exactly this is what their repeated call for an economic government comes down to. France was supported in this previously, e.g. by the then president of the European Commission, Romano Prodi, who described the Stability and Growth Pact (SGP) in 2002 as being simply stupid, and by the German government when it was threatened with sanctions in 2003 and joined France in the ultimately successful endeavour to dilute the rules of the SGP in 2005. After all that, was there still anybody who expected a strict monitoring of the rules agreed upon in the treaties? They just were not really accepted and therefore not taken seriously – neither by the member states nor by the European Council nor by the European Commission, the custodian of the treaties. Not surprisingly, for many years the financial markets did not believe in the no-bailout clause either and were ready to give loans to southern European EMU member states at roughly the same interest rates as to Germany, France and others. Only recently did they change that in the wake of drastically differing debt dynamics. Besides public budgets in Portugal, Italy, Greece and Spain going off course, other failures of economic policies in those countries contributed to the crisis. Because interest rates fell to low levels after joining the EMU, not only loan-financed government expenditures were raised but also wages and the indebtedness of private actors. This overly increased internal demand and damaged international competiveness. Since prices and wages in these countries thus increased much more rapidly than in the rest of the EMU, this resulted in a revaluation of the real exchange rates and higher current account deficits. In addition, the purchase of real estate, especially in Spain and Ireland, was not only made attractive by low interest rates on bank loans – the rates at times were lower than the comparable German ones – but also by government support. Furthermore, the standards for the prudential control of banks and other financial institutions as well as taxes were consciously kept low to attract more business to that area. This applies especially to Ireland. All this is further evidence of the fact that membership in

Contributors to this Forum

Wim Kösters, Ruhr-Universität Bochum and Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen, Germany.

Paul De Grauwe, University of Leuven and CEPS, Brussels, Belgium.

Daniel Gros, Centre for European Policy Studies (CEPS), Brussels, Belgium, and CEPR.

Waltraud Schelkle, London School of Economics and Political Science, London, UK.

Deborah Mabbett, Birkbeck, University of London, UK.

Desmond Lachman, Resident Fellow, American Enterprise Institute (AEI), Washington DC, USA.

1 W. Kösters: Challenges Facing European Monetary Union – Rules and Assignment or Discretion and Coordination?, in: Intereconomics, Vol. 45, No. 2, 2010, pp. 86-89.

2 Frankfurter Allgemeine Zeitung, 4 June 2010, p. 177.

the EMU was not taken seriously, because it shows that the "original sin" of a monetary union was systematically neglected by the countries now in crisis. It is well-known that a member state of a monetary union no longer has the ability to overcome public overindebtedness by printing money. Having said that, every member country sticking to the rules of the EMU should have realised and explained to its citizens that there will be no bailout and that the responsibility for public budgets will rest with that country. To my knowledge this was not publicly communicated and adequately discussed in any country before entering the EMU. On the contrary, in the crisis countries, but also in many other EMU member states, economic policy was conducted as if the country had never joined the EMU and agreed upon binding rules. In particular, it was not realised that with the creation of the single market and the monetary union, systems competition had been markedly enhanced and that national economic policy had to meet the new challenges implied by this. The reasons for these obviously serious policy failures can either be a fundamental misunderstanding of the political necessities of a monetary union or simply sloppy policy in the hope of somehow getting away with it and being able to blame somebody else later on. The reason for the present crisis is thus a systematic neglect of the basic rules of the EMU agreed upon in the Maastricht Treaty over many years. This disgrace was not ended by the European Commission, the European Council, the member states, the European Courts or the European Parliament but instead by the financial markets' demands for higher interest rates for the sovereign debt of crisis countries to compensate for higher risks. The European Council called these speculative attacks and decided not to make banks liable but rather the taxpayers in the EMU countries. It declared that this was the only way to rescue the euro.

Consequences of the Rescue Packages

The euro crisis, first of all, showed the world that the EU was unable to govern the EMU properly. In doing so, it disgraced itself. It was not able to guarantee the keeping of the rules which the member countries had previously agreed upon in international treaties. The International Monetary Fund (IMF) had to be called in and relied upon to make the conditions of the programme credible. Due to the US dominance of the IMF, this has increased the American influence on the EMU. In addition to these external effects, the EU suffered a blow to its reputation in the eyes of its citizens by de facto changing the treaties. The no-bailout clause and other basic elements of the governance structure of the EMU – declared unchangeable again and again in the past – were now simply overruled without saying what will replace them. The credibility of the basic governance principles was thus heavily damaged if not destroyed. The room for discretionary policy was markedly widened, and the ECB was made less independent and was brought closer to everyday politics. Since this – as stated above – is in the interest of France and EMU southern member states, it cannot be removed easily. Preserving the status quo, however, would mean that instead of following respected rules, decisions would have to be made case by case, making policy reactions slow and open to moral hazard because the incentives for crisis countries to consolidate public budgets and adjust their economic policies to the challenges of higher systems competition in the EMU would be significantly lower. This would surely be the start of a full-fledged European transfer union making countries with sound economic policies pay for those with sloppy ones. This will, of course, not be sustainable but will instead significantly increase the danger of the EMU breaking apart, since Europeans' weariness concerning European integration will rapidly rise. In spite of the large volume of the rescue packages, the interest rates of the crisis countries stayed high and even increased further after the decisions. Contrary to the expectations of the European Council, Ireland had to claim help from the EFSF. Speculation still abounds that Portugal and even Spain could be next. It is, therefore, urgent to end the period of uncertainty over the basic principles of the governance of the EMU, particularly as the debate over the proposals of the EU Commission and the decisions of the EU Council in October 2010 have not led to a calming down of the financial markets.

EU Commission Proposals and EU Council Decisions

As stated above, the credibility of the EU was damaged by the euro crisis. The main task, therefore, must now be to find new credible and efficient rules for the governance of the EMU. The German government made some initial proposals on 19 May 2010, demanding a tightening of the rules of the SGP to enable faster sanctioning in the deficit procedure as well as the withdrawal of voting rights in the Council of Ministers if a country violates the budget rules. In addition, a procedure for the orderly insolvency of member states should be introduced. Whereas France first supported the demand for the withdrawal of voting rights, others rejected it vociferously. On 23 September 2010 the German federal ministry of finance made more detailed proposals with respect to an automatic sanctions mechanism. In order to speed up the deficit procedure, it should be the EU Commission that imposes sanctions, which then could only be prevented by a qualified majority in the European Council. The EU Commission published its proposal on

29 September 2010, taking up the German position and adding mechanisms for the prevention and correction of macroeconomic disequilibria including sanctions for excessive wage and price increases as well as current account balances. On 18 October 2010 the German Chancellor Merkel and the French President Sarkozy reached an agreement which was then largely taken up by the task force headed by the President of the EU Council, Van Rompuy. In this French/German compromise, Germany stepped down from speeded up, automatic sanctions in favour of getting France's support for a change in the treaty and an orderly state insolvency procedure. The treaty change should create the legal basis for a permanent crisis intervention mechanism to safeguard financial stability in the EMU. On 29 October 2010 the European summit confirmed this in principle without deciding, however, upon a withdrawal of voting rights and a tightening of the SGP. The EU Commission was appointed to elaborate a proposal by December 2010.

Preliminary Conclusions

It is not yet clear what the new governance structure of the EMU will be and what that will mean for the sustainability of the euro. Some first conclusions, however, can be drawn. As was to be expected, France rejected the idea of automatic sanctions so that in the future, as in the past, likely "potential sinners" in the EU Council will have to judge over "actual sinners". A tightening of the SGP therefore cannot realistically be hoped for. The proposals of the EU Commision with respect to mechanisms for the prevention and correction of macroeconomic disequilibria are not sound and do not serve the stated purposes. This is the case because macroeconomic disequilibria are hard to detect in advance or even in the aftermath, and in addition the development of wages, prices and current account balances is not under the control of governments. The coordination by markets cannot be substituted for by government coordination.[3] The EU Commission's plans with respect to this should, therefore, be abandoned. The envisaged treaty change is a double-edged matter. Most probably only a small change will be agreed upon to keep the ratification process simple. Most observers expect that Art. 122 will be supplemented to allow for financial assistance not only in the case of a natural disaster but also in the case of a threat to the stability of the monetary union as a whole. Chancellor Merkel is fighting for a treaty change because she fears that otherwise the German Constitutional Court could decide against a continuation of the EFSF or its successor. Anyway, a treaty change in the above-mentioned manner would qualify the no-bailout clause even if its wording in the treaty were unchanged. If the treaty were changed only for the sake of creating a basis for a permanent fund for financial assistance, the no-bailout clause would lose its meaning. If, however, an efficient procedure for the orderly insolvency of member states of the EMU were agreed upon at the same time it would look different, because then the financial market actors would run a higher risk of experiencing capital losses from holding government bonds. This would raise risk premiums and consequently interest rates early on if a country ran higher public deficits. This would cause automatic sanctions by the markets and not by political bodies. Thus, under present conditions the sustainability of the euro depends on the establishment of a credible and efficient insolvency mechanism for the member states of the EMU, since at the moment we cannot trust in finding a majority in the EU Council in favour of a tightening of the SGP and automatic sanctions imposed by the EU Commission. If, however, the EU Council should not recognise the necessity of this reform and act accordingly, the danger of a "disorderly" haircut and of the EMU breaking apart becomes a very real one.

3 Gemeinschaftsdiagnose Herbst 2010, Deutschland im Aufschwung – Wirtschaftspolitik vor wichtigen Entscheidungen, Munich 2010, p. 8.

Paul De Grauwe

A Mechanism of Self-destruction of the Eurozone

At the insistence of Germany, the member countries of the eurozone appear to have agreed to introduce a sovereign debt default mechanism. They even seem to be willing to codify this into a new treaty – an extraordinary step.

My contention is that this is a very bad decision that will make the eurozone more fragile by making financial crises an endemic feature of the eurozone.

Before presenting the argument, I want to make the point that the proposed sovereign debt default mechanism is based on a wrong diagnosis of the causes of the debt crisis in the eurozone. The purpose of the mechanism is to reduce the scope for moral hazard: by making it clear to investors that their investments in sovereign eurozone bonds are not guaranteed, these investors will apply more scrupulous risk analyses preventing irresponsible governments from issuing excessive debt. Thus, the proposed mechanism is based on the view that the sovereign debt crisis in the eurozone is the result of irresponsible behaviour by governments that exploited the implicit bail-out guarantee while private investors had no incentive to discipline these governments.

This interpretation of the source of the debt crisis in the eurozone has become popular mainly because it fits the Greek crisis well. It cannot, however, explain the debt crisis involving the other eurozone countries, where the root cause of the debt problems is to be found in the unsustainable debt accumulation of the *private* sectors. From 1999 until 2008, when the financial crises erupted, private households in the eurozone increased their debt levels from about 50% of GDP to 70%. The explosion of bank debt in the eurozone was even more spectacular and reached more than 250% of GDP in 2008. Surprisingly, the only sector that did not experience an increase in its debt level during this period was the government sector, which saw its debt decline from 72% to 68% of GDP. Ireland and Spain, two of the countries with the most severe government debt problems today, experienced the strongest government debt ratio decreases prior to the crisis. These are also the countries where private debt accumulation was the strongest.

After the crash of 2008, the private debt accumulation in the eurozone forced the governments of the eurozone countries to allow their own debt levels to increase. This was achieved through two channels. The first consisted of governments actually assuming private debt (primarily bank debt). The second operated through the automatic stabilisers set in motion by the recession-induced decline in government revenues. As a result, the government debt to GDP ratios started increasing very quickly, but only *after* the eruption of the financial crisis. This increase was necessary to save large segments of the private sector. It has nothing to do with irresponsible governments that failed to be disciplined by financial markets. The reverse is true – financial markets were undisciplined and governments demonstrated responsibility by saving them.

A sovereign debt default mechanism in the eurozone is not the appropriate response to the eurozone's debt crisis because it is based on the wrong diagnosis of its origin. More importantly, its implementation is downright dangerous and will make the eurozone more rather than less prone to financial crises. Let me elaborate on this point by introducing an analogy with the Exchange Rate Mechanism (ERM) that existed in the EU prior to the start of the eurozone.

The ERM was a fragile institutional arrangement that led to frequent crises. In the end, it proved to be unsustainable. The reason for this fragility is well-known. The member countries of the ERM pegged their exchange rates to each other. The understanding, however, was that they could reconsider this peg and devalue their currencies at any time. The existence of this devaluation option created an unstable environment prone to speculative attacks. Sometimes there were good reasons for the speculators to expect that one or more countries would devalue their currencies (e.g. because their wages and prices were out of line with the others). At other times these expectations of an ensuing devaluation seemed to drop out of the blue sky. Whatever the reason, once expectations of a devaluation had become established among speculators, a self-fulfilling dynamic would be set in motion, the end result of which would be that the country involved lost out. This always consisted of the same ingredients: when speculators expected a devaluation, the central bank of the country concerned had to raise the domestic interest rate. This, however, was costly for the domestic economy and for the government budget. As a result, the cost-benefit ratio of maintaining the fixed exchange rate increased, leading to a temptation to devalue. As speculators "smelled" this, they intensified their speculative activities, leading to a further increase in the interest rate and a further deterioration of the cost-benefit ratio of keeping the exchange rate fixed. In most cases, this made devaluation inevitable. Ultimately, the ERM collapsed.

The proposed sovereign debt default mechanism introduces an incentive structure for speculators and national authorities that is similar to the ERM. When the member countries of the eurozone solemnly announce (it will be solemn, since it will be enshrined in the Treaty) that investors face governments that have the option of applying a haircut on outstanding bonds, two things will happen. First, as the perceived risk on these bonds increases, their interest rates are likely to go up. This is the effect that has been stressed by the President of the ECB, Jean-Claude Trichet. Defenders of the sovereign default mechanism counter this argument by claiming that such a system also gives the national governments stronger incentives to maintain discipline in budgetary matters. However, the recent increases in government bond spreads since the announcement of the sovereign debt default mechanism seem to vindicate Trichet.

The second problem, however, is much more serious. This is the ERM problem, which will also become the problem of the eurozone. When governments solemnly declare that they will devalue their government bonds in times of payment difficulties (that's what a haircut means), this will introduce into the eurozone the speculative dynamics that destroyed the ERM. Once investors expect payment difficulties from a particular government, they will sell those bonds, thereby raising the interest rate on the bonds. This is exactly what speculators in the ERM did when they expected a devaluation of the currency – they sold the currency.

This mechanism has already been triggered in the eurozone during the last year and a half, but it has been contained by the commitment of the other countries to provide financial assistance. The declared objective of the proposed sovereign debt default mechanism is to replace mutual financial assistance. As a result, it opens the gates for unrestrained ERM-type speculation. Once the option to devalue becomes declared policy and replaces mutual financial assistance, the speculative dynamics will become unstoppable as the same incentive structure that led to the collapse of the ERM is introduced to the eurozone: governments whose bonds are sold will face a higher interest rate, making the service of their debt more difficult. This changes the cost-benefit ratio of maintaining full debt service and increases the temptation to devalue the bonds (i.e. applying a haircut). Investors "smelling" this temptation will intensify their selling of sovereign bonds, thereby increasing the cost-benefit ratio even further.

I do not want to argue that the proposed sovereign debt default mechanism would transform the eurozone into a system identical to the ERM system. Even with a sovereign debt default mechanism, the cost of default (devaluing the debt) in the eurozone is likely to remain higher than the cost of devaluing the currency in the ERM. Nevertheless, by making it easier to devalue sovereign debt, the eurozone moves in the direction of the unstable ERM incentive mechanism. Governments will have a higher incentive to devalue their debt when the sovereign debt default mechanism is in place, and this can be sufficient for speculators to make a move.

Thus, one should expect that the introduction of a sovereign debt default mechanism will make debt crises in the eurozone more frequent and more harmful. Whether the eurozone can survive such a structural increase in the frequency and intensity of debt crises remains to be seen. I suspect that, if implemented, the sovereign debt default mechanism will destabilise the eurozone and ensure its demise.

Under pressure from a German government that is concerned only about its own reputation, the other eurozone governments seem to have consented to do something sovereign governments should never do – announce that they may debase their own debt. The sovereign debt default mechanism, if implemented, will lead the eurozone governments to downgrade their own sovereign debt. There is no surer way to self-destruction.

It is paradoxical that so many today consider a sovereign debt default mechanism as the formula to avoid future debt crises in the eurozone. In my view, its attractiveness is due to the fact that it promises a solution to the debt problem without having to call upon a solidarity mechanism in the eurozone. Financial solidarity is deemed politically unacceptable in a number of countries. The truth, however, is that a monetary union can only survive if there is a willingness to provide mutual financial assistance in times of crisis. No monetary union can survive without such a solidarity mechanism.

The solution, therefore, is not to implement the sovereign debt default mechanism, which will lead to the demise of the eurozone, but to give a permanent character to the European Financial Stability Facility; even better, it could be transformed into a European Monetary Fund along the lines suggested by Gros and Mayer[1], including strong enough conditionality so as to reduce the risk of moral hazard.

It used to be the mainstream view among economists that a monetary union could only work if there was an explicit insurance mechanism. In fact, economic analysis prior to the start of the eurozone stressed that a monetary union should be coupled with a budgetary union. The latter would then allow a country experiencing a negative shock to obtain an automatic transfer, enabling it to absorb the shock better. This view was already put forward in the MacDougall report in the 1970s.[2] When the Maastricht Treaty was signed, it appeared that this mainstream economic view had been discarded completely. The eurozone was created without any insurance mechanism, and it was said that a monetary union could work without any budgetary union. Many economists were sceptical[3], and it now turns out that this scepticism was well-founded.

The surprising thing is that so many have been living under the illusion that the eurozone would work well without such an insurance mechanism. The official view was that the eurozone did not need an insurance mechanism and certainly not a budgetary union. If the member

1 D. Gros, T. Mayer: Towards a European Monetary Fund, CEPS Policy Brief, 2010, http://www.ceps.eu/book/towards-european-monetary-fund.

2 EC Commission: Report of the Study Group on the Role of Public Finance in European Integration (MacDougall Report), Brussels 1977.

3 See P. De Grauwe: The Economics of Monetary Integration, 1st Edition, Oxford University Press, 1992.

countries abided by the rules of the Stability and Growth Pact, that would be sufficient for the smooth operation of the eurozone.

Let me compare the eurozone prior to the crisis to a city with a fire code aimed at minimising the risk of a fire spreading. The eurozone's official view amounts to saying that since there is a fire code, the city does not need a fire brigade. Clearly we all recognise the naivety of such a view. Certainly at some point, someone will not abide by the fire code or there will simply be some bad luck (say lightning) which causes a fire to break out. Not having a fire brigade then leads to a disaster. This is analogous to the case in the eurozone, which had a fire code but no fire brigade. Sure enough, somebody failed to follow the fire code rules and a fire broke out. A fire brigade had to be created out of the blue. This took a lot of time, allowing the fire to spread to the rest of the city. When the fire brigade was finally set up, it first wanted to punish the guilty party before working to extinguish the fire. No wonder the fire became impossible to contain.

The main reason an insurance mechanism was not attached to the eurozone has much to do with fears that such a mechanism would create incentives for member countries to behave irresponsibly. However, this moral hazard problem, although a serious one, is not the only problem facing the eurozone countries. The monetary union has also dramatically increased the interconnectedness of financial markets. For example, 75% of the sovereign Irish debt is held by institutions in the other eurozone countries. Thus, the Irish government's payment difficulties affect institutions – mainly banks – in the other eurozone countries, leading to the risk of a new banking crisis. It is easy to say that one should teach a lesson to irresponsible governments; it is more difficult to consider the consequences of this moralistic attitude on the financial system in the eurozone as a whole. It is precisely because of the interconnectedness of financial markets in the eurozone that an explicit and permanent insurance mechanism should be an essential part of a monetary union. Failure to create such a permanent mechanism dooms the eurozone.

Daniel Gros

The Euro Sovereign Crisis: The Difficult Transition to Private Sector Involvement

The "euro crisis" started in early 2010 when it emerged that the Greek government had for years been doctoring the official data on its deficits and debt for years. The real figures were so bad that many market participants decided that Greece would probably not be able to fully service its debt. As a result, the government of Greece could not obtain the financing it needed to fund its current deficit and the rollover of the portion of the debt coming due. As financial markets reacted nervously to the prospect of a sovereign insolvency, the eurozone government put together a package of about €110 billion of bilateral and IMF credits with the aim of fully financing the remaining deficits and other obligations for the next three years. At the time, Europe's leaders solemnly agreed that Greece was a unique and special case and that no other country would ever need financial support. However, it soon emerged that the markets did not regard Greece as an isolated case. Only weeks after the Greek rescue, financial markets went into such a tailspin that a new and much larger financing mechanism had to be hastily created during a dramatic weekend in early May: the European Financial Stability Facility (EFSF), which was supposed to be able to count on a total of €750 billion in potential funding for governments in need. Together with an intervention of the ECB in the "dysfunctional" bond markets, this package did restore some stability to financial markets.

However, during the summer of 2010, risk premiums on the government bonds of the four "fiscally challenged" countries (Portugal, Ireland, Greece and Spain) started to increase again. The deterioration in market sentiment accelerated after a Franco-German agreement in Deauville was endorsed by the European Council of 29 October. This proved to be a watershed, because it appeared to have changed the ground rules for the markets for peripheral euro area debt. All 27 Member States signed up to the need for a (small, technical) revision of the Treaty in exchange for a permanent crisis resolution mechanism. The latter constituted the key new element, because the Council Conclusions explicitly specified that the new, permanent mechanism should foresee the involvement of private creditors.[1] The Council Conclusions of 29 October did not specify how private creditors might be asked to contribute to any future rescue operation under the new, still to be defined mechanism. But market participants had to take as given that something would be forthcoming.

Ireland became the first victim of deteriorating market conditions when it transpired that the losses on real estate lending in the Irish banking sector were considerably higher than what had been estimated a few months earlier. The case of Ireland is a key to understanding the nature of the challenge facing the euro area. Essentially it confirms that in a crisis, banks and the government are so intertwined that it does not matter whether it is the sovereign which is over-indebted (Greece) and thus drags down its banks or whether, on the contrary, it is the banking sector which is insolvent and drags down the sovereign (Ireland).

The task for a European Monetary Fund (EMF) would be to deal with a sovereign in difficulties. Ex post it does not matter much whether a government is over-indebted because it overspent or because it saved a banking system which was really too big to save. The case of Ireland is so important because closer inspection shows that the government debt crisis was not unavoidable.

Ireland: An Avoidable Crisis?

The Irish government debt saga was both entirely predictable and entirely avoidable.

It was predictable because the underlying problem had been evident for some time – a property bubble which ended with a bust and left a massive housing overhang. This had to lead to huge losses for the banks, which had fuelled the bubble with reckless lending. As usual, the local regulators pretended at first that there was no problem, but as the losses mounted, investors pulled the plug. This is what happened this summer as the Irish banks were shut out of the interbank market and depositors started to withdraw their funds.

The government debt crisis, however, could have been avoided. As the losses in the banks kept on increasing, the Irish government had a choice: it could walk away from the insolvent banks in order to keep the Irish sovereign solvent or it could support the banks and thus put the entire nation at risk. The Irish government chose the latter, thereby transforming a potential banking crisis into the second sovereign debt crisis in the eurozone. Why?

The key argument in Ireland was that any attempt to even try to agree on a rescheduling with bondholders would have led to a run on deposits. However, this run is happening now anyway because by guaranteeing bond holders, the government has become de facto insolvent, so that its guarantee for depositors does not carry much value. Moreover, the government would have needed much less support from the EFSF if it had to take care of depositors only and not bondholders as well.

There was also enormous pressure from Ireland's European partners not to initiate a default of the three largest Irish banks because of the fear that this would have meant a "second Lehman". This rings hollow. The liabilities of the Irish banks in difficulties amount to about 1% of those of the euro area banking system. Lehman Brothers was several times larger than any of the Irish banks. It had hundreds of thousands of derivative contracts outstanding and was a counterpart to almost all major financial institutions worldwide. By contrast, the business of the Irish banks was local and involved no significant use of derivatives. The exposure of the euro banking system to the Irish banks in difficulties is vastly overestimated, because the official statistics are inflated by the loans of euro area banks to their subsidiaries in the offshore sector in Dublin.

Of course, a sudden bankruptcy of the Irish banks would have been disruptive. But this was not the only option. The Irish government (as the de facto most important stakeholder) could have invited the holders of the senior debt of the major Irish banks to initiate rescheduling or restructuring talks (while continuing to pay interest on time). Such an announcement, even without a default on any payment obligation, would of course have affected the rating of banks throughout Europe (and the mere mentioning in a local Irish newspaper that this option might be considered led to a sharp sell-off in the banking sector throughout Europe). But it is difficult to understand why the ECB and others could claim that any invitation to the bondholders to share the burden would have been a catastrophe after the stress tests of July of this year had led the authorities to proclaim that the European banking system was stable and that only a few marginal banks needed more capital to survive renewed stress in the government bond markets.

1 The other elements mentioned in the Council Conclusions, namely strong conditionality and the role of the IMF, are more likely to cement the status quo.

The argument that any burden-sharing with bondholders would result in a financial market meltdown is also belied by the fact that the Irish banks' junior debt holders accepted a tough write-down of their claims without the financial market taking any notice.

That a sovereign does not have to stand fully behind even virtually state-owned entities is illustrated by the experience of Dubai. In this sheikdom, the conglomerate "Dubai World", the country's biggest enterprise and certainly as "systemic" as any Irish bank for Ireland, did default because the paymaster of the United Arab Emirates, Abu Dhabi, had insisted that creditors had to share the burden (much as Germany insists today in the EU). After some tough negotiations, *all* creditors did indeed agree to a rescheduling which preserved the nominal value of the claims but stretched the repayment period and lowered the interest rate to 1% for five years. This is exactly what Ireland would have needed from bondholders. Today the credit default swap spreads for Dubai are lower than for Ireland even though the country is now considering the restructuring of a second large systemic conglomerate.

It is ironic that Ireland's EU partners and the EU authorities strongly supported the point of view that it was not appropriate to inflict any losses on the senior bondholders of the banks but are now starting a discussion on when and how private investors should be involved in future rescues of countries which might have bankrupted themselves by saving their banks.

A Botched Transition?

One simple way to describe the turmoil in euro area debt markets is to consider it a collective rush to the exit by investors. Yields on government debt of the peripheral euro area countries are skyrocketing because investors do not really know what the risks are. The official stance wants to be reassuring and it might be summed up in the following way: Investors should not worry since the current bailout mechanism (the European Financial Stability Facility, EFSF), which has worked so far without any haircut for bondholders, will continue to be applied until about 2013. Only after that date would any new mechanism open the door for losses for private investors, and only for debt issued after that date.

Markets do not trust in this message because it is not credible and does not make economic sense.

The official line that the danger for private investor losses would arise only for debt issued after the new mechanism kicks in in 2014 does not make economic sense, because it suggests that the entire stock of debt issued before that date should be safe and thus implies that the insolvency problem arises only in a distant future. However, investors know that both Greece and Ireland face an insolvency problem today and the no-bailout clause in the Maastricht Treaty does not allow for any legal guarantee on the existing stock of debt. Moreover, for too many investors, Portugal looks like Greece in terms of poor growth prospects and insufficient domestic savings to fund the public sector deficit. And Spain clearly has to grapple with a similar problem as Ireland, namely an outsized real estate bubble which has left a huge housing overhang and probably large losses in the banking sector. The problems of Portugal and Spain might be less severe than those of Greece and Ireland, but this is apparently not enough to induce investors to buy the government debt of these countries.

Moreover, in a crisis, banks and the government share the same fate; thus, there is an acute danger of large-scale withdrawals of deposits from the banking systems of these countries. This implies that any crisis mechanism will have to have sufficient funds to cover not only the financing needs of the government but also of the banking system. In the case of Ireland and Greece, this function has so far been taken care of by the ECB. The Irish crisis started when the ECB indicated that it felt its normal financing mechanism had been abused by the Irish banking system, which had obtained funds from the ECB amounting to over 60% of GDP. Should there be a run on Spanish banks, their liquidity needs could quickly run into the hundreds of billions of euros, an order of magnitude greater than that of the Spanish government, at least in the short run.

So far, the investors trying to exit first have been made whole. Holders of Greek debt maturing now are being repaid courtesy of the €110 billion bailout programme, and holders of Irish bank bonds have been given a guarantee by the Irish government, whose promises have in turn been underwritten by the EFSF, which will also provide funds to make sure depositors with Irish banks can get their money back today.

The problem with this approach is that it creates the wrong incentives. Investors have now learned that the first ones to sell will be safe. The situation resembles that of a crowded cinema with only one exit. Everybody knows that in case of fire, only the first to leave will be safe. This implies that even the faintest whiff of smoke, the remotest danger of a fire, can trigger a collective rush to the exit. The size of the exit, of course, determines the likelihood of a stampede: if the exit looks comfortably large, the public will be much more likely to remain calm, even if parts of the room are already bellowing smoke.

For the financial market "cinema", the size of the exit is given by the funds available to make short-term investors whole. Unfortunately, the size of the EFSF looks inadequate to finance a collective exit by short-term investors. When the EFSF was created, it was assumed that the only problem was to ensure the financing of government deficits of the four prospective problem countries (Portugal, Ireland, Greece and Spain). From this perspective, the headline figure of €750 billion for the entire EFSF "package" looked adequate. However, the founders of the EFSF did not take into account the enormous short-term liabilities of the banking sector which, in a crisis, effectively become government debt, as the case of Ireland has again demonstrated so vividly. The EFSF in its current form might be just enough to guarantee the public debt of the four problem countries, but certainly not their banking sectors as well. For example, the Spanish banking sector alone has short-term liabilities of several hundreds of billions of euros. To return to the cinema analogy: investors know that the exit is not large enough to allow them all to squeeze through at the same time. It will be first come, first served.

What to do then? The official line so far has been "no default", meaning no default by countries or by any bank can be considered. If this line is to be continued, the exit door must immediately be made much wider and huge fire extinguishers must be at hand. In other words, the EU, the IMF and the ECB must show investors that they have enough funding to finance the exit of all short-term investors at the same time. This might work: a show of overwhelming force might restore calm to the markets. But it is risky: if investors exit nevertheless, the required funds might be so large that the populations in the creditor countries revolt.

Concluding Remarks

Europe's political leaders have come to realise that they cannot go on forever with the current policy of bailing out every investor in sight and have publicly announced their intention to move to a new regime under which investors might participate in losses. Unfortunately, they seem to be doomed to botch the transition, as investors are rushing to the exit today to avoid the increasing likelihood of losses tomorrow.

All that is known about the future regime is that it might bring a small chance of a large loss for investors. Unfortunately, the 28 November statement of the Eurogroup[2] is likely to reinforce the rush for the exit for two reasons.

First, the statement says only that support will be available on the basis of "a rigorous debt sustainability analysis conducted by the European Commission and the IMF". Without knowing anything about the parameters which will be used in this analysis, investors today have no way of even calculating the odds that Greece or any other country will pass the sustainability analysis in 2013.

Second, the statement also says that "an ESM loan will enjoy preferred creditor status". This implies that, should default materialise, the losses for private creditors might be very large.

The result so far has been an "investor strike" which could rapidly lead to contagion to the wider financial markets with a widening of spreads of other asset classes as well (interbank, corporate bonds, etc.). There is thus an urgent need to overhaul the transition to the new regime: patient investors should be rewarded and should be able to expect to be better off than those rushing to the exit. This requires two elements.

First, governments should not be pushed into insolvency just to save all banks. Concretely, this would mean that the Irish government (maybe a new one) would ask the holders of bank bonds to share in the losses, perhaps by offering them a simple debt for equity swap. Doubts about the solvency of the Irish government would then disappear quickly, and the guarantee the Irish government has given to depositors would no longer look so shaky. Something similar might have to be done for those parts of the Spanish banking system most exposed to the local housing market.

The second element would be to build into the permanent crisis mechanism (the ESM) a floor for bond prices and thus a ceiling for the losses investors can suffer. This was one of the key elements in the original EMF proposal by Gros and Mayer.[3]

By contrast, any announcement that future government bond issuance in the eurozone should contain "collec-

2 See Eurogroup: Statement by the Eurogroup, 2010, available at http://consilium.europa.eu/SuMedia/27706/statement%20by%20the%20eurogroup%2028%20nov.pdf.

3 D. Gros, T. Mayer: Towards a (Euro)pean Monetary Fund, Centre for European Policy Studies, 2010.

tive action clauses" (CACs) is unlikely to stabilise financial markets. Experience so far has shown that they tend to have a small impact[4] and the little impact that has been detected in the case of emerging market debt has been to increase the risk premium. The underlying reason is easy to understand: the existence of CACs should make it, at least marginally, more attractive for governments to default, and might make it easier to impose harsh terms for the creditors. This implies that the emphasis on the introduction of CACs in future bond issuance can only further destabilise markets.

The rush to the exit can be stopped and yields of longer-term bonds can fall relative to short-term ones only if investors anticipate that the future crisis management regime will be better than the current one. Only then will peripheral governments be able to finance themselves on a solid basis and at reasonable cost. The fundamental problems (fiscal, banking, competitiveness) would still be there, but they would be easier to manage with calmer financial markets.

4 N. Roubini, B. Setser: Bailouts or Bail-ins?: Responding to Financial Crises in Emerging Economies, Washington DC 2004; F. Giavazzi, A.O. Krueger, J. Pisani-Ferry, A. Sapir, J. von Hagen: A European mechanism for sovereign debt crisis resolution: a proposal, Bruegel Blueprint 10, Brussels 2010.

Waltraud Schelkle and Deborah Mabbett

The Van Rompuy Reforms: Type 1 and Type 2 Errors and One Small Bright Spot

In our contribution to the Intereconomics forum on "Challenges Facing European Monetary Union" earlier this year[1], we argued that the euro area needed a stabilisation fund that would provide some positive incentives for sound macroeconomic management as well as some insurance against tides of adverse sentiment in the markets, which we saw as procylical and likely to intensify problems of macroeconomic stabilisation. We were also critical of the ECB for relying on the ratings agencies to tell it which government bonds to accept on what terms. This, we argued, was an abdication of the ECB's responsibility to contribute to euro area stabilisation.

The Van Rompuy Task Force has not addressed the issue of positive incentives at all, but instead has returned to the disciplinarian language of the original Stability and Growth Pact (SGP). In this contribution, we explain why we think its approach is flawed. Not only are the proposed sanctions likely to heighten political tensions, but also the assessments on which they are based are likely to convict some governments of crimes they have not committed, while allowing others to pursue policies that worsen the euro area's growth prospects. We then take another look at the curious politics of the ECB. The crisis has seen the boundaries between monetary and fiscal policy crossed in several member states – most strikingly in Ireland. As a result, the ECB has been dragged into country-specific measures. We suggest that this will be a permanent feature of its life from now on, and it needs to find ways to use its influence constructively. Finally, we turn to the debate over the crisis resolution mechanism (CRM) and argue for once in defence of the German position. Requiring creditors to take a haircut when a country has recourse to the CRM could actually result in markets finally beginning to provide timely signals to governments that are pursuing unsustainable policies.

The Errors in the Proposed SGP Reforms

The Task Force solemnly proposes a return to the disciplinarian approach that prevailed before 2005. The Task Force wants more and earlier sanctions, namely for excessive deficits, debt, and imbalances. The new decision mechanism in the Council also makes it more likely that such sanctions will be imposed, as it no longer requires a qualified majority to confirm the recommendation by the Commission but a qualified majority to reject it (a so-called reverse majority). In the future, sanctions may be extended to non-euro area members, although

1 Beyond the Crisis – The Greek Conundrum and EMU Reform, in: Intereconomics, Vol. 45, No. 2, 2010, pp. 81-85.

instead of having to pay a fine, they may not receive certain funds from the EU budget.[2] No doubt many small dramas will be enacted under these rules. They will do nothing to remedy the economic problems of the euro area and will harm the popular legitimacy of the Commission, which will be clearly responsible, as never before, for punitive actions towards member states.

For the drafters of the original SGP, irresponsible governments were the most important potential source of macroeconomic instability, and fiscal deficits and debt were the key data to be monitored if the euro area was to thrive. We now know that this led to what statisticians call type 2 errors. Fiscal monitoring did not reveal the threats to macroeconomic stability that were bubbling up as the peripheral euro area countries enjoyed the effects of low interest rates. Spain, for example, performed adequately on the fiscal criteria, whereas stresses might have been identified if macroeconomic monitoring had paid more attention to private debt and current account imbalances. Conversely, fiscal monitoring could lead to type 1 errors or finding a problem where one did not exist. Belgium, a persistently poor fiscal performer, provides the leading example of this: it has a solid current account surplus and, before the crisis, managed to use lower euro interest rates to reduce its debt level slowly but surely.

Thus the Task Force is right to propose to monitor the "excessive imbalances position" of member states.[3] The list of indicators for such excessive imbalances has not been drawn up yet, but the report mentions "[c]onsumption developments, housing bubbles[,] the accumulation of external and internal debt" and "divergences in competitiveness".[4] So it seems that a lesson has been learned. But the disciplinarian fervour is yet again prone to rely on irrelevant evidence, thereby convicting governments of failures of macroeconomic management when they are not, in any meaningful sense, guilty.

The most striking source of potential type 1 errors is the suggestion that competitiveness should be monitored. Macroeconomic monitoring should be concerned with indicators that can be tackled with macroeconomic policies. Unit labour costs (the proposed measure of competitiveness) are a composite indicator of nominal wage developments and the evolution of employment (hours worked) relative to output. Governments could intervene to manipulate this measure, but it is far from clear that they should or even can in any predictable way. In the capitalist market economies of the euro area, it is for firms and wage bargainers to determine these variables in the course of searching for profitable business and employment strategies through their negotiations over wages and working time.

The Task Force proposes monitoring "imbalances", but it is clear that it really means "deficits". Member states with large and persistent current account surpluses are mentioned only once, when it is suggested that their "policies should aim to identify and implement the structural reforms that help strengthening their domestic demand and growth potential".[5] One cannot but wonder what these structural reforms might be: the demolition of the model of export-oriented growth and accompanying wage restraint that is apparently so deeply institutionalised in Germany, the Netherlands and Austria, perhaps? Seriously, structural reforms are an unreliable way to boost domestic demand and will actually make the problem of imbalances more difficult. The tax cuts that liberal-conservative governments in Germany and the Netherlands favour might do the trick, and perhaps more spending on social services would not go amiss. But of course this cannot be said, because the official EU line is to preach the doctrine of universal fiscal consolidation, available for everybody to read in the Commission's assessments of stability and convergence programmes. This advice may be appropriate for any one country looked at in isolation, but it is not constructive advice against the background of large macroeconomic imbalances within the euro area.

It would be much better to convince the governments of surplus countries that it is in their own interest to allow the debtors to repay instead of competing them into the abyss. The surplus countries' banks and pension funds would then be on the line as well, since they hold a good share of the sovereign debt. To suppose that the surpluses of one group of countries are caused by good fiscal policy and the deficits of the other group are due to bad fiscal policy is to commit both type 2 and type 1 errors at the same time. The surplus countries are deemed innocent of responsibility; the deficit countries found guilty. This is an achievement of sorts, as statisticians tell us that the occurrence of these errors normally varies inversely.

The ECB's Role in the Crisis Saga

The monitoring of current account positions will reveal that fiscal authorities are not the only force behind un-

2 Strengthening Economic Governance in the EU, Final Report of the Task Force to the European Council, Brussels, 21 October 2010.

3 Ibid., para 37.

4 Ibid., para 32.

5 Ibid., para 33.

sustainable imbalances. Attention will shift to the growth of private debt and booms in bank lending on the back of housing bubbles. As economists noted long before the crisis, national governments in the euro area have only fiscal instruments to deal with these problems. Tax policies can certainly have an impact on how attractive it is to incur mortgage debt; property taxes or windfall gains taxes on housing transactions could also help to restrain bubbles. But it is now clear that action should also be taken by monetary authorities. Macroeconomic stability is a monetary as well as a fiscal task. Paul De Grauwe has recently proposed that the ECB should accept its responsibility for asset market bubbles and impose, for instance, country-specific minimum reserve requirements on resident banks.[6] Of course, the ECB will resist the use of country-specific assessments and instruments rather than general interest rate policy, as this would expose it to a much more intense level of political debate.

One lesson of the financial crisis is that not only governments but also banks can pursue unsustainable strategies. The model of governance of the euro area, however, was based on the assumption that member states' commercial banks were all equally sound institutions managed according to common banking principles. We now know that national differences in banking regulation can have a profound impact on euro area stability. Regulators could monitor the strategies by which banks are increasing their leverage, restrain the erosion of loan-to-value ratios and control the spread of securitisation. They could also rein in loans to housing and construction that are based on overvalued collateral.

The ECB is already pursuing country-specific policies. This became apparent in a rather peculiar way when the ECB chose to settle unease about Greece's declining credit rating by announcing its continued willingness to purchase Greek bonds as part of its own version of quantitative easing. Now the Irish crisis has revealed another role, as it has become clear that ECB loans are supporting the Irish banking system to a much greater extent than in any other country. So long as the imperative of maintaining liquidity reigned, this was just a small wrinkle on the ECB's generally expansionary stance. But with recovery now under way in the heart of Europe, the ECB will want to rein in its asset purchases and lending.

6 P. De Grauwe: Why a tougher Stability and Growth Pact is a bad idea, VoxEU column, 4 October 2010, URL: http://www.voxeu.org/index.php?q=node/5615.

The deliberations of the Van Rompuy Task Force, with its huffing and puffing about fiscal discipline, are strikingly orthogonal to the Irish problem. The Irish government cannot be accused of profligacy in regular government spending; if anything, the government has sent the economy into a downward spiral thanks to its procyclical austerity programme. Until recently, markets praised the Irish government for doing all the things that the Greek government should do. The crucial step that Ireland took towards insolvency was to turn bank debts into sovereign debts by promising to guarantee the position of bank creditors. While tough on public sector workers and benefit recipients, the government has been lenient towards its political cronies in the banking and building sectors.

The crisis makes it clear now that the Irish government must make creditors share the losses of insolvent banks, or the resulting strain on Irish taxpayers will burden the economy for years. Such burden-sharing is arguably what the Commission has tried to do by forcing Ireland to turn to the European Financial Stabilisation Facility (EFSF) and the IMF. This intervention saw officials from outside Ireland trying to impose a solution in the interests of the taxpayers rather than the political elite, which is naturally devoted to its "sovereignty".

A standby agreement would also end the present situation in which the ECB is abused as a printing press to prop up the Irish banking system. It is a bitter irony and a damning verdict on the past strategy that this humiliation is inflicted upon the proudly independent central bank by a member state which accepts that its sovereignty is being ceded to market forces rather than shared with the union of which it is a member. Like the ECB, the Irish government prefers to let its actions be dictated by the markets rather than take advice from other political authorities.

Crisis Resolution

The one bright spot in these depressing stories is the possibility of a crisis resolution mechanism, not contained in the Task Force report but apparently under preparation on the request of the French and German governments. This mechanism provides an opportunity to correct the process whereby the financial markets create debt crises which member states can only calm by offering assurances of no default. The German vision is that the crisis resolution mechanism will see haircuts imposed on the national debt of member states that enter it. This should ensure that markets price in the risks of debt being discounted at a much earlier stage than they do now. If markets correctly assessed risk, countries pursuing irresponsible fiscal policies should find themselves facing an interest rate premium – a more salient and effective deterrent than any excessive deficit procedure.

The SGP as it stands prevents rather than supports this deterrent from operating. Intrusive fiscal surveillance inevitably declares budgetary policies to be a common responsibility, and however much the Commission and Council insist on the no-bailout clause, the markets see the common responsibility – why else would members accept the intrusion? At the same time, there is no fiscal substance behind this common responsibility, no central budget that could protect a government from being forced into austerity when the economy is already in the doldrums.

But it would be preferable and, in our view, even more effective if the markets would impose the haircuts on themselves. This calls for some innovation in public debt management. But then these unusual times are the right times for making the case for unorthodox measures, as monetary authorities have taught us. Robert Shiller has proposed to link returns on public debt to GDP growth.[7] Bulgaria has already experimented with such bond issue. It would mean that if bond markets drive an economy into recession, the burden of servicing the public debt would fall as well. This would make for the smoother pricing in of evolving risks to which countries can adjust instead of being pushed into crisis and towards default. Such a mechanism is not a silver bullet but would help to suppress the destabilising dynamic of high interest rates and low growth.

7 R.J. Shiller: Create Growth-Linked Bonds, Project Syndicate column 2005, URL: http://www.project-syndicate.org/commentary/shiller22/English.

Desmond Lachman

Europe Fiddles as its Periphery Burns

European policymakers remain in denial about the severity and the immediacy of the eurozone periphery's sovereign debt crisis. At a time when recent economic and financial market developments underline the intractability of the periphery's solvency problem, European policymakers mainly confine themselves to addressing the liquidity aspects of the crisis. And at a time when the periphery's excessive budget deficit train has long since left the station, European policymakers vainly wrestle with proposals to reform the eurozone's architecture in a manner that will prevent the future recurrence of budget profligacy. By so doing, they only delay facing up to the reality that the euro is presently well on its way to unraveling.

The Periphery's Solvency Problem

Among the more disappointing financial market developments over the past six months has been the very poor market response to the launching of Europe's massive financial safety net for its periphery. In May 2010, in response to the seizing up of the Greek government's access to financial markets, the EU and IMF put in place for Greece a three-year financial programme totaling €110 billion. This package was intended to assure investors that Greece's public sector financing needs would be fully covered for the next three years. At around the same time, Europe launched a €440 billion European Financial Stability Fund for its periphery while the IMF committed itself to lending €250 billion to that area.

This massive show of EU-IMF support was intended to convince markets that the public financing needs of Greece, Ireland, Portugal and Spain would be fully covered and that there was virtually no risk of a sovereign debt default in Europe's periphery over the next three years. Yet despite this unprecedented show of official financial force, by the end of November 2010, markets were demanding from the eurozone's periphery almost the same high interest rates as they demanded at the earlier peak in the eurozone debt crisis in May 2010.

The high market interest rates being demanded of the eurozone's periphery suggest that the market attaches a significant probability to the likelihood of default in the eurozone's periphery over the next few years. In so doing, markets appear to have grasped that the periphery's problems are more those of solvency than those of liquidity. In particular, unlike the European policymakers, markets seem to understand that the extraordinarily large budget deficit adjustments being required of the periphery cannot be achieved within the straitjacket of continued euro membership without provoking the deepest of economic recessions. And markets also seem to have grasped the idea that not only will deep recessions in the periphery seriously erode its tax base, but they will also undermine domestic political support for adhering to a path of IMF-imposed austerity.

Recent developments in Greece lend considerable weight to the view of those who believe that Greece's economic problems are more those of solvency than of liquidity. The European Commission is now in the process of revising its estimate of Greece's 2009 budget deficit upwards to more than 15 per cent of GDP. It is also now revising its estimate of Greece's public debt to GDP ratio at the end of 2009 upwards from 115 per cent to 127 per cent. This latter revision implies that, even if Greece were to fully comply with its IMF programme and even if the Greek economy were to hold up better than might be expected given the large degree of budget tightening being implemented, Greece's public debt to GDP ratio would reach more than 160 per cent by the end of 2012. It is little wonder then that markets are highly sceptical of Greece's ability to avoid eventually defaulting on its sovereign debt.

More disturbing yet is the mounting evidence that the Greek economy is already contracting at a much more rapid rate than was contemplated in its IMF three-year stand-by arrangement. It is doing so largely as a result of the brutal fiscal adjustment that the IMF has imposed on the country. It might be recalled that the IMF programme required of Greece ten full percentage points of GDP in fiscal measures in 2010 alone, an amount of fiscal adjustment that the IMF has never before imposed on a country within a fixed exchange rate system. And it did so at a time when markets had imposed on Greece the equivalent of seven percentage points of monetary policy tightening. It is little wonder then that already by the second quarter of 2010, Greece's economy was contracting at an annualised rate of 7.2 per cent. Nor is it any wonder that the Greek government is also owning up to the fact that its tax revenue collections are falling more than five percentage points short of target and that its IMF-agreed budget deficit target for 2010 will be missed by a significant margin.

Ireland's Hangover

In a number of important respects, after Greece, Ireland appears to be the eurozone member country most likely to default on its sovereign debt. As was the case in Greece, Ireland's budget deficit increased sharply to 14 per cent of GDP by 2009. And despite the early adoption of bold fiscal measures to address the country's public finance imbalances, the Irish budget deficit (excluding the massive one-off cost of the bank bailout) is expected to remain at an unsustainably high 12 per cent of GDP in 2010, the highest level in the eurozone. However, unlike the Greek case, Ireland's public finance problems were not the result of budget profligacy. Rather, they have been the product of a hangover from an uncontrolled credit binge.

In the early part of this decade, an orgy of Irish bank lending both helped to fuel the Celtic Tiger's economic miracle and gave rise to one of the world's most pronounced speculative property bubbles. In the two years since that bubble burst in early 2008, the Irish economy has contracted by a cumulative 12 per cent and unemployment has risen to over 14 per cent. Meanwhile, the country's public finances have deteriorated sharply as the government's property-based tax revenues collapsed and income tax collections were severely impacted by rising unemployment and declining incomes.

More ominously yet for Ireland's future public finance outlook, at the end of September 2008 the government announced a blanket guarantee on all of the liabilities of the main Irish-controlled banks. It did so in response to the inability of Anglo-Irish Bank, a major Irish bank, to roll over its debt and to fears of a contagious reaction affecting the other banks. Since the gross bank liabilities guaranteed by the government amounted to well over twice Ireland's GDP, the open-ended nature of the possible bank losses constituted a very large potential charge on the Irish government's finances.

Until very recently, markets turned a blind eye to Ireland's highly compromised public finances and to the massive potential cost to the Irish exchequer of the blanket bank liability guarantee programme. Instead, markets lavished praise on the Irish government for the bold and timely fiscal measures that it took in an effort to correct its rapidly eroding public finances. Markets were particularly impressed with the deep public spending cuts, especially in the area of public wage and benefit cuts, as well as with the government's capacity to withstand considerable economic pain.

In August 2010, there was an abrupt turnaround in market sentiment towards Ireland as doubts began to surface as to whether Ireland was any more solvent than Greece. These doubts were reflected in the subsequent widening in the spread between Irish bonds and German Bunds to as wide as 600 basis points, their widest levels since Ireland joined the euro. The factor triggering the sea change in the market's attitude was a further downgrading of Ireland's sovereign debt by the S&P rating agency. The market was particularly taken aback by S&P's estimate that Ireland's blanket guarantee could in the end cost the Irish government a staggering €80 - €90 billion, or the equivalent of between 50 and 58 per cent of Ireland's GDP. The market was also shocked by S&P's estimate that Ireland's banking sector problem could raise the country's public debt level to 130 per cent of GDP by 2012, a level not very different from that presently prevailing in Greece.

The Irish government is hoping that Ireland will somehow grow its way out of its public finance and public debt problems after having seen its GDP contract so sharply over the past two years. However, such hopes would seem to be fanciful in light of both the substantial amount of budget deficit cutting that lies ahead as well as the effective monetary policy tightening being forced on Ireland by the mounting financial market scepticism about the country's longer-run solvency. The IMF estimates that Ireland needs further fiscal tightening of at least 6 ½ percentage points of GDP over the next two years if the country is to hope to regain fiscal policy sustainability. At the same time, since the start of the year Irish interest rates have increased by more than 350 basis points while credit has become considerably more difficult to obtain. Further compounding Ireland's economic problems is the fact that deflation has now taken hold in the Irish economy, which both increases the real cost of borrowing and aggravates Ireland's real debt burden.

Kicking the Can Forward

European policymakers fully understand that a default in any peripheral eurozone country would likely trigger contagion to the other countries in the periphery. They also understand that a series of defaults in the eurozone's periphery would have devastating consequences for the European banking system. After all, the combined sovereign debt of Greece, Spain, Portugal, and Ireland is around US$2 trillion, and a major part of that debt sits on the European banks' balance sheets. The Bank for International Settlements estimates that French banks are particularly exposed to the troubles in the peripheral countries, since they have lent the equivalent of 37 per cent of France's GDP to those countries.

Realising the potential threat to Europe's banking system from a significant write-down in the periphery's sovereign debt, European policymakers have chosen to mask the periphery's solvency problem with a massive dose of liquidity. They have done so by putting in place a €750 billion support system for the eurozone's periphery in an attempt to convince markets that there is little risk of a sovereign-debt default anytime soon, since the financial needs of the periphery's public sector are being fully backstopped for the next three years. The main pillar of that support system is the European Stabilisation Fund, which will raise €440 billion in the market on the basis of loan guarantees from the sixteen eurozone governments.

The ECB is also playing a major role in Europe's efforts to forestall a full-blown sovereign-debt crisis. Since May 2010, the ECB has been buying the peripheral countries' bonds in the secondary market. More importantly, the ECB has been engaged in a backdoor bailout operation of these countries through massive rediscounting operations with their banks. It has done so to the point where ECB loans to the periphery now constitute more than 40 per cent of the ECB's overall loan portfolio.

Closing the Stable Door After the Horse Has Bolted

Rather than contemplate how the peripheral countries might exit the euro in an orderly fashion, European policymakers are now proposing to fortify the eurozone's architecture through treaty modification. At a recent European Summit, agreement was reached to extend the European Financial Stability Fund (EFSF) when it expires in 2013 and to require that private bondholders bear their share of the burden of future bailout exercises. In addition, it was agreed to introduce real penalties for countries that were in repeated violation of the budget limits of the Stability and Growth Pact.

While the treaty modifications now being proposed would have had great merit when the euro was launched in January 1999, one has to wonder how relevant they are today, at a time when the periphery's public finances have been compromised beyond repair and when there is every indication that the periphery's crisis is deepening. While the periphery's sovereign debt crisis is playing out in real time, past experience would suggest that treaty modification, which requires unanimous ratification by all European Union members, would take years to take effect. In addition, it would appear that the proposed reforms overlook the fact that the major part of the periphery's budget deficits is primary in nature. As such, even if the debt of the periphery were to be substantially written down, the periphery would still be left with very large budget deficits. And reducing these very large budget deficits to sustainable levels would still involve very deep recessions if such an exercise were attempted within the straightjacket of continued euro membership.

The End Game

The late Herb Stein, a well-known American economist, was fond of observing that if something cannot go on forever it will stop. This aphorism appears to be particularly apt for the current eurozone situation, since it would seem unreasonable to expect voters in the eurozone's north, and especially in Germany, to indefinitely acquiesce to the transfer of large amounts of bailout money to the eurozone's south in an effort to keep those countries afloat. And it would seem even more unreasonable to expect voters in the south to indefinitely endure the severe economic and social pain associated with continued euro membership and with the austerity measures attached to the financing that they receive from the north. This would seem to be especially true if voters in the south were to perceive (a) that they were being taxed so that onerous debt repayments could be made to foreign banks; and (b) that there was little prospect of their economies emerging anytime soon from depression-like conditions without the benefit of either a debt restructuring or an exit from the euro straightjacket.

In May 2010, a cautionary warning was sounded for eurozone policymakers in the North Rhine-Westphalian state elections. The voters of North Rhine-Westphalia, Germany's largest state, handed Angela Merkel's Christian Democratic Union a crushing defeat largely in protest at Mrs. Merkel's active role in the Greek bailout package. It would seem that electoral considerations of this sort would make it all but impossible to enlarge the EFSF when it expires in three years' time.

As recent ECB experience amply attests, European policymakers can use ECB financing to the periphery in principle as a much less transparent form of keeping the periphery afloat. The obvious advantage of using the ECB for that purpose is that the ECB's rediscount operations are not subject to the same close parliamentary scrutiny as are the budgetary appropriations required for the eurozone's other bailout operations. However, one would think that there have to be limits as to how much further the ECB can bend its rules. There also have to be limits as to how much further the ECB might be prepared to contaminate its balance sheet by accepting more collateral of lesser quality from the periphery's banks. Already, serious voices within the ECB, most notably that of Axel Weber, the President of Germany's Bundesbank, have been publicly raised about the longer-term advisability of further compromising the ECB's balance sheet and of using the ECB to conduct what are essentially budgetary operations.

European policymakers understand full well that a default in any peripheral country is almost certain to trigger contagion to the rest of the periphery. They are also highly cognisant of the fact that a wave of defaults in the periphery would more than likely precipitate a full-blown banking crisis in West Europe. These considerations would make one think that European policymakers in the north will not lightly turn off the financing spigot that presently keeps the periphery, and thereby the European banking system, afloat. Rather, one must expect that European policymakers will continue to kick the can forward in the forlorn hope that something might turn up to rescue the periphery. They might also do so in the hope that time might allow the West European banks to strengthen their balance sheets in a manner that would allow them to more easily absorb the shock of a sovereign debt default in the periphery.

The more likely trigger for the euro's eventual unravelling will be in the periphery itself. The Greek, Irish, Portuguese and Spanish governments already have the most tenuous holds on political power. A deepening of their economic and financial crises could very well result in the ascendancy of more populist governments which might be less willing to hew to the hair-shirt austerity programme being dictated by the IMF or to remain within the euro straightjacket. This is essentially what precipitated the demise of Argentina's Convertibility Plan in 2001. More recently, the new Hungarian government's spurning of the IMF in September 2010 would seem to be a poignant reminder that countries in the eurozone's periphery might very well also be tempted to turn their backs on IMF austerity. Another plausible trigger for the euro's eventual unravelling could be a heightening of the capital flight that is already under way in Greece and Ireland. Ample experience in earlier fixed exchange rate regimes suggests that capital flight can reach such proportions that countries are left with little alternative but to restructure their debt and to exit their fixed exchange rate arrangement.