Policy prescriptions for curing "eurozonitis"

The Greek debt crisis and other eurozone countries' responses to it have highlighted the vulnerability of the European single currency. Yannos Papantoniou, a former Greek finance minister, sets out the steps now needed

The global financial crisis and eurozone's sovereign debt crisis have highlighted a fundamental truth of economics: large imbalances in either the real economy or the financial sector, or both, are bound to disrupt the functioning of economic systems. The question now is how best to cure "eurozonitis" before it spreads and becomes chronic.

Within the eurozone, large external imbalances have been allowed to emerge over the last decade. The competitive position of peripheral countries deteriorated sharply vis-à-vis the eurozone's core countries, but their governments ignored all the warnings and turned a blind eye to the accumulation of credit-fuelled bubbles and public or private debt. They also failed to take anti-cyclical fiscal measures or to promote structural reforms. Their large external deficits were matched by surpluses in Germany and other core economies, and the persistence of these imbalances led to the transfer of excess savings to the periphery, creating the conditions for extensive borrowing – particularly in high-inflation countries on account of the "one size fits all" euro interest rate – in both the private and public sectors.

In fiscally responsible countries like Spain, excess savings resources were borrowed by the private sector and were often invested in what later became bubbles – housing assets. The bursting of these bubbles created insolvency problems for banks, while the bubble-induced recession coupled with the disruption produced by the financial crash and the associated collapse of exports led to an explosion of budget deficits and so to full-blown fiscal crises.

In fiscally profligate countries like Greece, the chain of events was more straightforward. Excess savings resources were mainly borrowed by the government, leading directly to the fiscal crisis. Debt

growth took on catastrophic proportions after the 2008 financial crash as the ensuing recession led to drastic cuts in private spending and an automatic capture by the government of redundant savings resources.

An interesting and critically important part of the story is that much of the debt induced by the savings glut in core economies ended up both indirectly and directly on the government books in the weaker peripheral economies. The fiscal crises that resulted raised the risk of sovereign defaults and the potential break-up of Europe's monetary union. And this is what makes reform of the eurozone's governance system so very urgent and critical to the euro's survival.

The Commission together with Ecofin and the eurogroup should be given additional powers – if necessary through a treaty change – for enforcing budget recommendations

There are now sharp divisions of opinion in the eurozone as to the future shape of its governance. I would advocate a pragmatic approach that addresses the defects revealed by the crisis, which can be summarised as follows:

- The ineffectiveness of the mechanisms in the Stability and Growth Pact (SGP) for ensuring fiscal discipline. Sanctions have never been imposed, and member countries were allowed to maintain excessive deficits for long periods. And their debt levels remained unchecked.

- The origin of the imbalances problem lies in the external sector, witness the persistent co-existence of large external surpluses and deficits in the core and peripheral countries respectively. External imbalances of such a size and duration reflect conflicting trends in eurozone countries' competitive positions and demand policies. Core economies, principally Germany, promoted structural reforms and themselves followed restrictive demand policies. In peripheral countries, reforms stalled while lax policies prevailed in the fiscal or the monetary field – or both. The bubbles resulting from excessive private sector deficits were translated into fiscal deficits as banks faced solvency problems following the financial crash. Neither external nor private sector imbalances are subject to surveillance within the framework of the SGP. They were effectively left unnoticed, and thus allowed to engineer the debt crisis.

- The absence of bail-out mechanisms. The Maastricht treaty's "no bail-out clause" left the eurozone unarmed when the debt crisis erupted. A bail-out fund for Greece was eventually set up on an ad hoc basis, while the newly-formed European Financial Stability Facility (EFSF) lacks both the permanent structure and enough funding to inspire confidence in the markets.

- The inadequate regulation and supervision of the European financial system. When the conditions leading to the crash were building up, the systems did not work. Interventions were patchy and unco-ordinated as a result of disparate rules

and because there were so many relevant authorities. The crisis also revealed the absence of mechanisms appropriate for large cross-border financial institutions deemed "too big to fail".

Reform of the eurozone's governance system should aim to remove these weaknesses. Otherwise, the monetary union will remain vulnerable to being overcome by the next crisis. A number of steps are clearly essential to effective governance:

First, the tightening of fiscal discipline. Discipline involves a higher degree of joint responsibility as well as sanctions for countries that exceed the deficit limits of the SGP. Sanctions have not worked in the past, and are unlikely to work in the future unless they are made fully automatic. But this isn't acceptable as it would not fully take into account cyclical or exceptional factors. A qualitative improvement would therefore be to transfer some responsibility for setting and monitoring deficit limits to supranational institutions such as the European Commission and the national finance and economy ministers grouped in Ecofin and the eurogroup so as to reinforce "shared responsibility" and create a sense

MATTERS OF OPINION

Eurozone citizens unmoved by €-jitters

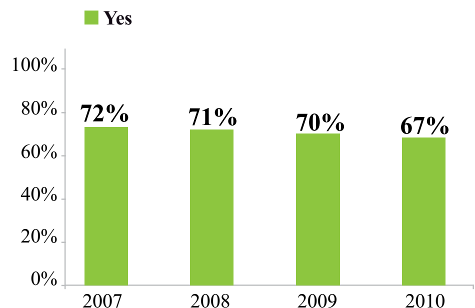
Market jitters over the single currency in 2010 do not appear to have greatly troubled ordinary citizens in the eurozone. In a survey last September of perceptions of the euro by Gallup on behalf of the European Commission, two-thirds of people living in eurozone countries said that having the euro was a good thing for Europe, a fall of only 3% compared to 2009.

Of the 16 eurozone countries surveyed (Estonia, the 17th member, joined in January 2011), support for the benefits of the euro was strongest in Ireland (84%) and Luxembourg (81%), and weakest in Portugal (61%). Better educated and younger people tended to see the euro as a good thing.

More people overall also said that the euro had made price comparisons easier, and that the single currency had made travelling easier and cheaper. Only in Italy and Cyprus did more people disagree than agree with the second statement.

When it came to the euro's impact on cross-border banking charges, fewer than one in three (29%) said the currency had helped reduce charges. Rather more (34%) said that it had not reduced bank charges, while the largest proportion (37%) said they did not know or wouldn't answer. □

Was having the euro a good thing for Europe? (Euro area)



Source : Flash Eurobarometer n°306, 2010

of collective purpose. Sanctions as well as national rules for deficit setting should complement the new fiscal policymaking architecture. The Commission together with Ecofin and the eurogroup should be given additional powers – if necessary through a treaty change – for enforcing budget recommendations.

Second, policy co-ordination must be instituted that would extend control of the imbalances to the external and private sectors. The huge external deficits of peripheral countries relate to their loss of competitiveness, but they reflect restrictive German policies too.

Germany is understandably reluctant to modify the internally successful economic model it has built based on fiscal contraction and structural reforms. But if Berlin insists on maintaining this model then further crises will inevitably recur. And if it were to propose that other countries emulate it, Europe including to some extent Germany itself, would be condemned to a prolonged slump which might even generate a new round of fiscal crises, possibly forcing some peripheral countries to default on their debts.

Overall policy co-ordination should clearly be strengthened. To this end, not only fiscal deficits and debt levels but also financial and competitiveness indicators should be included by the Commission in the surveillance process. Fiscal policies should be determined by taking into account the growth prospects of the eurozone as a whole as well as the fiscal, financial and competitive positions of individual countries. Fiscal contraction in one part of the area should be compensated by a more expansionary stance in some other part. Keynesianism in any one country may be dead but, as international policy actions to overcome the global crisis have amply demonstrated, global Keynesianism is very much alive. Most countries along with international institutions like the IMF have recognised this truth. Ignoring or neglecting demand at international level risks leading towards a replay of the 1930s.

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Third, creating an effective bail-out mechanism in the shape of a European Stability Mechanism (ESM) that would finance assistance programmes for eurozone countries in trouble. Funding should be substantial enough to guarantee the stability of the eurozone as a whole, and should come through fiscal transfers from member states. "Orderly default" procedures involving the private sector should follow established international practice, as implemented in IMF programmes. Otherwise, they risk overcharging borrowing costs, particularly for heavily indebted countries.

Issuing Eurobonds, based on a common rather than national liability could also help alleviate the position of over-indebted

eurozone members. The interest rate each country would pay could depend on the interest rate it pays in its own market, although on account of common liability it would be lower. Specific mechanisms should ensure that borrowing costs for core countries do not rise. Eurobonds lack the conditionality that would effectively trigger fiscal consolidation in over-indebted countries, so they can't provide the whole answer to the debt problem. They could, though, supplement the creation of an explicit solidarity mechanism such as the ESM and be linked to it as an additional instrument of assistance.

Fourth, reinforcing financial supervision at the European level, tightening regulation and setting up effective crisis resolution mechanisms. The creation of the European Systemic Risk Board as well as of separate authorities for European banking, insurance and occupational pensions along with securities and markets are steps in the right direction. But they are still insufficient, because national authorities have succeeded in retaining the core supervisory powers. In any case, a financial stability fund is needed for bailing out banks that are in trouble, and at the same time instruments such as naked short selling and Credit Default Swaps should be subjected to tougher regulation.

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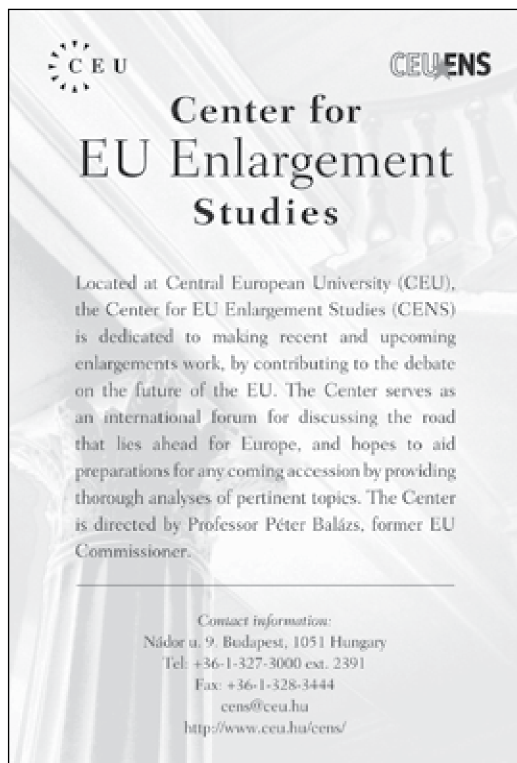

The euro is unique; it is a monetary, not a political union. It possesses a central bank but not a Treasury. The central bank can provide liquidity in times of crisis, but only a Treasury can address problems of solvency. Short of a fully-fledged fiscal union that at present doesn't seem feasible, substitute mechanisms and procedures must be established to ensure the proper functioning of the euro and ensure its deserved success. □

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