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How Europe Can Muddle Through Its Crisis

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As Europe's financial market contagion spreads to systemically important eurozone members, the region is echoing with "end-game scenarios" (Johnson and Boone 2010) and demands for major new steps by European policymakers (Financial Times 2010). Among these would be a European "fiscal transfer union," a new common eurozone bond, action by the European Central Bank (ECB) to monetize sovereign debts, and finally a eurozone breakup itself.

No doubt the status quo cannot go on forever, but it would be a mistake to think that European policymakers are free to bring about clean, expeditious, and decisive reforms. The European Union is a complex hybrid entity, neither sovereign state nor international organization. Analogies with experiences of continental-sized sovereign states like the United States or to the record of past interstate agreements do not provide a road map for solving Europe's problems. Too many powerful political constraints to make any of these scenarios possible prevent easy answers.

I believe, on the other hand, that the European Union will do "whatever it takes" to save the euro and the eurozone. This could mean steps toward these solutions, but by other means that would be politically messy and certainly inelegant—though potentially effective.

Why are any of the above-mentioned scenarios unlikely? A European fiscal union with regular, institutionalized and large transfers between eurozone members (analogous to a federal European budget) is not politically feasible in Europe. It wasn't possible in the 1990s when Chancellor Helmut Kohl of Germany and President Francois Mitterrand of France wisely resisted the idea, and it won't be possible until a genuine pan-European identity emerges, which may never happen.

A "common eurozone bond," to replace much or all of the existing sovereign member state debt, will always be vetoed by Germany—long concerned about granting direct and unconditional transfers to "undeserving peripheral countries" and incurring higher German borrowing costs.[1] With the principal taxation capacity in Europe residing with the individual member state governments, a common "Eurobond" would ultimately lack the democratic legitimacy to be feasible.

Monetizing sovereign debts by having the ECB print money and buying up large amounts of peripheral debt would be theoretically feasible in the short term, but it would also run counter to both EU and German law and be vetoed by both the European Court of Justice (ECJ) and the German Constitutional Court.

An exit from the eurozone, as I have said in other essays, would bring catastrophic costs for anyone who tried it—including Germany (Kirkegaard 2010a). Deceptively easy recommendations to quit just because the going inside the

1. Note that financial markets in essence granted the eurozone the functional equivalent of a "common eurozone bond" from the beginning of the euro until 2008, when they lent freely to all member states at German levels. This "freebie" to the periphery, however, would not be repeated in an actual common eurozone bond as lower borrowing costs for the periphery would come at the expense of higher costs for Germany.

euro has now gotten tougher ignore the simple fact that life on the outside will still be significantly worse. No democratic government inside the eurozone will likely go there.

The reason for believing that EU leaders will "do whatever it takes" to save the euro lies in the historical reality of the European Union as a "permanent crisis response mechanism," conceived after World War II to knit the region together and produce economies of scale in the global market, stabilize exchange rate volatility with a common currency, and cope with new problems that now include climate change. Despite its difficulties, the European Union remains a frustrating, though innovative, "work in progress."

Three constraints limit EU leaders in dealing with the current crisis.

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First, eurozone members operate under limited national sovereignty and cannot unilaterally default on parts of their debts as Russia did in 1998 or Argentina did in 2001. Membership of the European Union politically and practically requires that any reductions in the sovereign or sovereign-guaranteed senior bank debt be done in collaboration with a country's European partners and the ECB. It will never be in the national interest of a eurozone and/or EU member to turn its back on the rest of the club.

Second, a new round of referenda on EU treaty changes is out of the question. Germany's desire for an amendment to the 2009 Lisbon Treaty, requiring that future creditors be forced to take haircuts in the event of another financial crisis, has set up a new internal tension within the European Union. Germany wants such a revision to take place without a referendum (allowed under article 48 for simplified revisions). But debtor countries like Ireland are likely to insist on a referendum unless they win concessions from Germany and other creditor countries that would make it easier to pay off their obligations.

Third, EU leaders cannot permit solutions that pose undue risks of a systemic bank run inside the eurozone like the run that followed the Lehman Brothers bankruptcy two years ago. Bank vulnerability to such risks is clear because of the importance of banks (as opposed to bond markets) in the EU financial system. That vulnerability is also the result of weak capitalization levels in the eurozone banking sector, the region's anemic growth rate, the poor health of banks' loan books, and the fiscal deficits of EU sovereigns standing behind the banks. (As Simon Johnson (2010) has repeatedly pointed out, the danger is heightened by the huge size of the banks relative to country GDP).

As a result of these factors, the talk of imposing haircuts on senior bank debt holders has been unacceptable so far, even to the point of Irish pensioners being forced to take the hit first in the bailout of their financial system (Kirkegaard 2010a).

Despite these problems, it is not clear that this dire situation will persist forever. By playing for time and offering liquidity support for troubled countries now, Europeans are counting on a return of growth leading to higher general bank capital levels, improved government fiscal positions and less need of such haircuts. Even more to the point, a rejection of restructuring of senior bank debt or even sovereign debt right now does not rule out such a step in the future.

Clues about the likely direction of future EU crisis response compromises can be seen in the decisions so far—the bailouts for Greece on May 9–10 and Ireland on November 28.

First, the Greek package: In the two-stage "grand bargain" (Kirkegaard 2010b) in May, the ECB extended its balance sheet by first accepting "junk collateral" and then purchasing "junk" directly through its Securities Market Program (SMP).[2] The SMP is a flexible crisis-management tool reflecting the unusual legal independence of the ECB.[3] Purchases through it are at the discretion of the ECB Governing Council, where decisions may be taken by simple majority vote, in which each of the 22 members have just one vote.[4] It would thus be a mistake to underestimate the willingness of the council to use it if the survival of the euro is at risk.

For now it makes no sense for the ECB to tell the world just how big its SMP "bazooka" is. If the bank were to announce a large SMP target,[5] it would lose the value of ambiguity. In reality, markets are better reassured by an implied willingness from the bank to do whatever it takes. And if there

2. As of November 26, the ECB (2010b) had purchased €67.2 billion of assets through the SMP.

3. With its treaty-defined independence, the ECB is immune to the kinds of "threats" from members of Congress to reform the Federal Reserve's "dual mandate" following its decision to launch quantitative easing II (Harding 2010). The ECB answers to no individual government or parliament.

4. The ECB Governing Council consists of the six members of the ECB Executive Board, plus the 16 heads of the national banks of the eurozone member states. On January 1, 2011, the Estonian central bank governor will become the 23rd member of the ECB Governing Council.

5. Note that the ECB Governing Council could in theory, if it so desired, also stop sterilizing SMP purchases, turning SMP interventions into activities more akin to quantitative easing.

is a fixed ceiling on what the central bank is willing to do, traders in private sector banks might try to profit from speculating against it.

Separately, to deal with the crisis, EU and/or eurozone member states have offered an assistance package focused initially on countries in the periphery, which imposes austerity in the form of structural reforms to achieve growth. This package is accompanied by "bailout money" from the IMF to provide liquidity support for first Greece (€110 billion, of which €30 billion comes in the form of an IMF standby arrangement (IMF 2010) and the remaining €80 billion from the eurozone countries, excluding Slovakia). In addition, the broader eurozone has established the European Financial Stability Facility (EFSF) with €440 billion ready to be used and the European Financial Stabilization Mechanism (EFSM) with €60 billion.

These instruments vary in how they work. The EFSF is a eurozone-only facility, designed to issue bonds or other debt instruments to raise the funds for loans to troubled eurozone countries. Its bond issues would be backed by guarantees from euro area member states of up to €440 billion in accordance with their share in the paid-up capital (EFSF 2010) of the ECB. In effect, the EFSF and SMP are backed in the same way by the same eurozone governments.[6] The EFSM, however, is backed by all the EU-27 members through their respective share of the European Commission [EC] budget.[7]

In short, the EU policy response can be separated into two categories: real economy measures, i.e., austerity and structural reforms; and liquidity facilities, i.e., all the facilities (SMP, EFSF, EFSM, and Greece's special package) for financially troubled member states. While it is true that the ECB's SMP is technically not a "lending facility," but a "systemic stability-enhancing facility," aimed at ensuring depth and liquidity in dysfunctional financial markets (ECB 2010a), the ultimate outcome is similar in the form of lowering the borrowing costs for crisis-stricken members.

The European Union's real economy measures are aimed at lowering deficits (austerity) and raising longer-term growth potential (implicitly trying to deal with solvency). But the concept of expanding growth in the short term through consolidation is largely a myth. That is true at least in fixed exchange rate regimes in periods of depressed regional growth, though political leaders sometimes try to solicit political support by declaring that a tougher austerity program will produce growth benefits (IMF WEO 2010). At the same time, liquidity facilities provide financial stability AND an incentive for politically tough "real economy measures."

All these steps for Greece derive from standard textbook directives of spending cuts, economic reforms, and hopes that in three years, the economy can improve and sustain its debt level. As I have suggested before, Greece is unlikely to enjoy such a turn of events.

As for the Irish package, on November 28 the European Union and the IMF provided an external support package of €67.5 billion, accompanied by an additional Irish pledge of €17.5 billion from domestic sources.[8] The duration of the Irish assistance, however, was up to 10 years, longer than the three years for Greece. Irish aid comes at a slightly higher interest rate of about 5.8 percent (Ireland Department of Finance 2010). The euro group simultaneously offered Greece a substantial maturity extension in its May loan package from three years up to lengths matching Ireland's terms, which also implied slightly higher interest rates for Greece.

While the precise details of the terms are not yet available, it seems inevitable that the maturity extension will force a reduction of the net present value (NPV) of the original eurozone loans to Greece. (The IMF on December 2 expressed its willingness to also extend the maturities of its loans to Greece [Atkinson 2010].)

Put another way, Greece has won an explicit amount of "debt relief." Indeed, in the words of EU Commissioner Olli Rehn, this was carried out "to ensure the debt sustainability of Greece." Implicitly, these decisions entailed a direct "fiscal transfer" from the euro group (minus Slovakia) under the stealthy heading of "aligning maturity extension to Irish terms."

The willingness of the euro group to take this step (while not shouting about it) is a very important development with significant implications for the future. It means that small conditional fiscal transfers between member states are possible "to ensure debt sustainability," albeit still under another name.

On November 28, EU leaders provided further details on a permanent European Stability Mechanism (ESM) to replace the EFSF (Eurogroup 2010) after mid-2013. The ESM will be subject to unanimity in decisions, have preferred creditor status (junior only to IMF loans), and rules providing for a case-by-case participation of private sector creditors through Collective Action Clauses (CACs) after 2013.

6. The EFSF has provisions built in that, in order to secure its AAA rating, requires each participating government to guarantee (EFSF 2010) up to 120 percent of its share. The ECB paid-up capital structure has no such provisions.

7. The European Commission (2010) budget consists of both "own resources" (mostly customs duties and sugar levies) and national member state contributions, with the latter by far the largest share.

8. This pledge of additional Irish domestic support makes the deal somewhat uncertain, given the upcoming Irish election (Kirkegaard 2010a). These concerns should be clarified once the IMF, ECB, and EC inspection teams have examined the true health of the Irish banks.

All these elements offer an outline for the permanent mechanisms to ensure fiscal and financial stability in the eurozone. Combined with other institutional measures to strengthen economic coordination in the European Union announced earlier,[9] (European Council 2010) these mechanisms will be mostly "market based."

In its current form, the EFSF—at €440 billion, with only about €250 billion in actual lending potential—is not sufficient to offer any meaningful assistance to a large member state. But it is also clear that the EFSF can be expanded if circumstances dictate. The problem is that such an expansion might be interpreted as preparation for a crisis involving a large state, leading to a self-fulfilling prophecy. As a result, the EFSF or its replacement ESM can probably only be expanded at a time of financial market calm or another acute crisis. It would thus be wise for EU leaders not to set a number for its size.

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The record of anticipating crises is not good, however. EU leaders failed to deal with the short-term solvency concerns of Greece, Ireland,[10] and Portugal. By providing Ireland with longer-maturity loans and offering Greece a degree of "debt relief," they deferred the issue of tough actions into the future.

The problem of the unsustainable "old debt stock" and "new debt flow" will not go away by stating that all debt issued before 2013 will not be subject to haircuts. Greece and perhaps also Ireland and Portugal will face enormous difficulties in issuing new debt after 2013 if they still carry the burden of an unsustainable mountain of "old pre-2013 debt." Because such new debt will be easier to restructure, it will be prohibitively expensive to market. An ESM cannot hope to succeed until all eurozone countries are on a fiscally sustainable path.

An ultimately sustainable debt level for a country is a moving target. It seems evident, however, that the debt burden of Greece by 2013 or later of around 150 percent of GDP will not be sustainable. Consequently, Greece will at some point need to conduct a carefully negotiated debt restructuring. A similar process may also be necessary for Ireland (depending on the scale of bank losses) and perhaps Portugal.

The ultimate scale of losses from such a restructuring cannot be discerned at this point. For Greece, such losses will depend on the success of the current IMF program. It is clear, on the other hand, that the realized losses in a credible restructuring designed to achieve a sustainable long-term fiscal path will run into the several hundreds of billions of euros. Greece's current outstanding sovereign debt amounts to more than €300 billion, to which can be added Irish and Portuguese sovereign debts of €125 billion and €140 billion,[11] not to mention additional private debts that could end up as obligations of their governments.

Who will end up with this bill? Clearly the IMF will not take any losses. The liabilities will instead be distributed among the private sector and the eurozone countries. This will undoubtedly be a very messy process. If private debt holders do not end up paying everything, eurozone governments will have to fill the gap.

Any willingness of the eurozone governments to accept losses on Greek debts was signaled by the maturity extension of the loans to Greece announced on November 28. In addition, as eurozone governments, particularly Germany, set their sights on implementing the ESM within a relatively short time frame, they will likely be open to an expeditiously negotiated Greek solution facilitating such an outcome. Accepting some of the losses in a Greek restructuring may be a price Germany is willing to pay for setting up the ESM promptly.

One could imagine a haircut on claims as nonpreferred "eurozone claims on Greece" from the May package are transferred into preferred creditor claims of the permanent ESM. Such a step would be carried out in the name of ensuring Greece's debt sustainability. Incorporating the "ad hoc Greek program" into the permanent ESM would then entail a fiscal transfer between eurozone member states—only by another name. Something similar could be imagined for transferring the temporary EFSF/ESM-funded package for Ireland into the ESM.

Would Germany be willing to entertain such a deal? This would depend on just how badly Berlin wants an operational ESM by 2013. But at least the timing is decent right now with Germany enjoying its fastest economic growth in 2010 since reunification (Vits 2010). By accepting some losses through this "implicit fiscal transfer," Germany would still get to impose some

9. Among other things, these measures make it harder to cook the data "Greek style" and provide the European Commission with earlier powers to warn against lax fiscal policies.

10. In the case of Ireland the "solvency issue" is as much a potential "won't pay" as "can't pay."

11. Data from Q2 2010 (Eurostat 2010).

negotiated pain on the banks through "private sector participation." It would also get its way on setting up an ESM provision requiring unanimity for any future disbursement, which would grant effective veto power to Germany. Influencing the way the ESM is structured and the timing of its implementation is the strategic goal for which Berlin should be willing to contemplate accepting some losses on existing peripheral debt.

While the details and final size of the ESM design are still sketchy, it will be modeled on the existing EFSF model. This means that the ESM will have the structure of a de facto permanent "common Eurobond"—i.e., a bond guaranteed by all the eurozone members.

In its pure form, such a bond is surely not acceptable to any German government. It would simply be seen in Berlin and Frankfurt as driving up the cost of German borrowing, implicitly transferring the gains to the periphery by lowering their cost of debt. This would be a big step toward a standard "fiscal union," the very thing that eurozone politics have ruled out.

But an "ad hoc ESM-Eurobond" would be a "conditional Eurobond." Given the intended requirement for unanimity among eurozone governments for its use, peripheral countries could only gain access with the explicit blessing and conditioning of Berlin and other eurozone members. Such a bond would not entail automatic fiscal transfers between eurozone members, but only "conditional fiscal transfers" payable if the recipient country "does its homework first."[12]

Such an "ESM-Eurobond" would also offer EU leaders a future policy tool with which to counteract the worst asymmetric shocks inside the eurozone. It would be extremely beneficial for the long-term stability of the monetary union. To avoid inevitable market speculation about whether the ESM would be big enough for Spain, Italy, or another big country, it would probably be better not to specify the size of the ESM. Instead, like the ECB SMP, the ESM would be a flexible instrument that policymakers could calibrate.

Moreover, by being conditional rather than automatic, the implicit fiscal transfers made possible by an ESM-Eurobond would be subject to less moral hazard. Eurozone governments would know, first, that it would only be accessible after the dreaded visit of the IMF, ECB, and EC inspection team. (Ask Prime Minister Brian Cowen of Ireland about the effects of such a visit on your political future.) Similarly the ESM—through its CACs and explicit option for private sector haircuts—would lower moral hazard in the form of higher interest rates for governments running irresponsible policies.

The conditional "tough love transfer" of an ESM-Eurobond is likely to be the only politically feasible opportunity to truly deepen European fiscal coordination. Automatic transfers as carried out by the US federal government budget are simply not politically possible among the still largely sovereign members of the eurozone. Ironically, however, this explicit conditionality means that the European Union actually may end up having a permanent instrument to "discipline" the domestic policies of its members.

Given the history of states opposing interference from Washington, the US federal government frequently resorts to imposing conditions or offering incentives along with its funding grants. Even so, the US government's powers over the states do not come close to the coercive force of IMF programs in Greece or Ireland. Once a "conditional ESM-Eurobond" is in place, eurozone members would have few ways to resist the power of the larger entity. Automatic transfers to local governments rob the center of tools to impose its will.

As illustrated by the examples of Italy's history of trying to spur growth in the impoverished southern Mezzogiorno region, or federal Germany's experiences in the former East Germany, automaticity in economic transfers is not what the European periphery needs now. Fiscal federalism is not the answer for Europe. Rather, permanent "fiscal conditionality" is.

Transfers to peripheral European countries accompanied by conditions or incentives, on the other hand, might protect the European Union from extreme populism in member states.

An ESM-Eurobond could thus preempt superficially inviting but flawed policies. It could prevent such adverse developments as a European version of California's Proposition 13 curbing a state's ability to raise taxes. It could also force a member state to clean up misleading pension accounting in a way the US government has failed to do (Cooper and Walsh 2010) in states like Illinois.

Some interesting bond market dynamics between individual member states and a sizeable ESM can be foreseen. The mechanism would, like the AAA-rated EFSF, issue new debt to provide a conditional transfer to a member state. A sizable ESM AAA-rated issuance—which would be required to provide aid to any large member state in the eurozone—would probably be priced above the current eurozone benchmark German government bond, but definitely below a peripheral sovereign eurozone bond. This would hurt demand for both traditional sovereign issuers, where investors would be tempted to snap up the extra yield on offer relative to the German govern-

12. A conditional ESM-Eurobond would further have the advantage of probably being easier to legally justify under the EU Treaty Article 122.2, which enables "financial support for member states in difficulties caused by exceptional circumstances beyond member states' control." A conditional ESM-Eurobond would be legally classifiable as implemented under "exceptional circumstances."

ment bond, while other investors could get some exposure to the eurozone periphery through an ESM-Eurobond without taking on too much peripheral sovereign default risk.

The costs to Germany in the form of higher interest rates would arguably be alleviated by a much stronger German political hand in influencing the details of the "ESM conditionality" to other member states receiving financial aid. With German structural budget balance and presumed lower borrowing needs kicking in by 2016, this might be a bargain for Berlin.

Meanwhile, weaker peripheral countries face a problem not dissimilar to that of US municipal bond issuers versus the US Treasury bills: how to sell their debt when the market is flooded with such bonds without having to pay too high interest rates? Obviously, offering tax exempt status for eurozone peripheral sovereign bonds to sweeten the deal, as cities and states in the United States do, would not make any sense for any individual peripheral member. It would raise the total cost of their debt. Access to aid from an ESM-Eurobond would consequently come with both conditionality and, other things being equal, a higher cost of debt for peripheral countries.

In summary, Europe has the option to muddle through its current crisis and produce a pragmatic compromise among member states that would see a permanent ESM introduced with an option to issue an ad hoc Eurobond. Such a bond would provide a conditional fiscal transfer in the form of a nominally preferred creditor loan to eurozone members hit by an asymmetric economic shock. The prize for the ESM's backers in Germany and elsewhere would be to accept some sort "pan-European socialization" of at least some of the losses associated with restructuring the existing debts of eurozone member states that currently are insolvent (e.g., Greece), so as to return them to a sustainable fiscal path before entering the ESM.

This would be neither a European fiscal union nor a straight forward Eurobond. Nor would it entail an outright sovereign default, or involve the ECB simply printing money. It would not see the eurozone break up. Remember that EMU stands for Economic and Monetary Union, but the economic cooperation has until now been lacking. These steps would at last add a small conditional "e" to the monetary union. It would thus be a typical messy European compromise.

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