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The Coming Resolution of the European Crisis

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Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.

—Jean Monnet

When things get really difficult... suddenly solutions which seemed impossible become possible… Because of this, the crisis represents an opportunity. I'm not saying that I enjoy being in a crisis, but I'm not worried. Europe always moved forward in times of crisis. Sometimes you need a little pressure for certain decisions to be taken.

—Wolfgang Schäuble[1]

1. Cited in Reuters, available at http://www.reuters.com/article/2011/12/14/us-europe-merkel-schaeuble-idUSTRE7BD0IU20111214.

SUMMARY

Doom and gloom about the euro abounds. An increasing number of commentators and economists, including here at the Peterson Institute, have begun to question whether the common currency can survive.

The economic and financial problems in the euro area are clearly serious and plentiful. The area is in the midst of multiple, frequently overlapping, and mutually reinforcing crises. A fiscal crisis is centered on Greece but visible across the southern euro area and Ireland. A competitiveness crisis is manifest in large and persistent pre-crisis current account deficits in the euro area periphery and even larger intra-euro-area current account imbalances. A banking crisis was first evident in Ireland but is now spreading throughout the area via accelerating concerns over sovereign solvencies.

This policy brief argues that these fears are overblown. We believe that the European crisis is political, and even largely presentational, and that this conclusion is key to understanding how the crisis has developed and how it will be resolved.

The lack of confidence in the euro is first and foremost rooted in a crisis of fundamental institutional design. The Economic and Monetary Union (EMU) adopted in the 1990s comprised an extensive (though still incomplete) monetary union, with the euro and the European Central Bank (ECB). But it included virtually no economic union: no fiscal union, no economic governance institutions, and no meaningful coordination of structural economic policies.

It was assumed by the architects that economic union would inexorably follow monetary union. However, there was no pressure to create an economic union during the expansion period prior to the Great Recession. When the crisis hit, the contradiction triggered severe market reactions that continue to this day.

There are only two alternatives. Europe can jettison the monetary union. Or it can adopt a complementary economic union. This brief argues that, for all the turmoil, Europe is well on its way to completing the original concept of a compre-

hensive economic and monetary union, and that Europe will emerge from the crisis much stronger as a result.

From its creation in the 1990s, the common currency has lacked the crucial institutions to ensure that financial stability can be restored during times of acute uncertainty and associated market volatility. The task before euro area leaders today therefore ranges far beyond putting together a big enough financial bailout to restore market confidence. They must rewrite the euro area rule book and complete the half-built euro house. This means they must combine creative financial engineering, to resolve the immediate crisis, with a wave of new institutions to strengthen the real economy and restore sustained growth.

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The key to understanding the evolution of the euro is to observe and analyze what the Europeans do rather than what they say. They have resolved all of the many crises that have threatened the European integration project, throughout its history of more than half a century, in ways that strengthened the institution and moved the project forward. At each key stage of the current crisis, they have in fact done whatever is necessary to avoid collapse. We have complete confidence that, in the crunch, both Germany and the ECB will pay whatever is necessary to avert disaster. The politics of each, as described below, assure this result.

The problem for the markets is that these central players cannot say that this is what they will do. There are two reasons. First, a commitment to bailouts without limit would represent the ultimate in moral hazard. It would relieve the debtor countries of the pressure necessary to compel them to take tough political decisions and maintain effective adjustment policies. Second, each of the four main classes of creditors—Germany and the other northern European governments, the ECB, private sector lenders, and the International Monetary Fund (as a conduit for non-EU governments like China)—will naturally try to transfer as many of the financial losses on Greek government bonds or European banks as possible onto the other three, limiting their own costs and risks in the process.

Every policymaker in Europe knows that the collapse of the euro would be a political and economic disaster for all and thus totally unacceptable. Fortunately, Europe is an affluent region with ample resources to solve its crisis—it is a matter of mobilizing the political will to pay rather than the economic ability to pay. Europe's key political actors in Berlin, Frankfurt, Paris, Rome, Athens, and elsewhere will thus quite rationally exhaust all alternative options in searching for the best possible deal before at the last minute coming to an agreement. It is a messy and indeed cacophonous process that is understandably unsettling to markets and inherently produces enormous instability. Miscalculation, and thus disaster, is always possible under such a scenario. But the process relies on financial market volatility to incentivize solutions that will ultimately resolve the crisis. Europe's overriding political imperative to preserve the integration project will surely drive its leaders to ultimately secure the euro and restore the economic health of the continent.

THE POLITICAL ORIGINS OF THE EURO

The geographic extent of a currency's use is generally dictated by the existing borders of the issuing country. Hence it is often the result of prior wars, decolonization or other violent historical incidents. The scope for the use of the euro as a supranational currency union crafted in peacetime, however, has not been dictated by such past events. Rather, it reflects contemporary political decisions made by elected European leaders.

The entire European project was of course driven by the existential geopolitical goal of halting the intra-European carnage that had persisted for at least a millennium and reached its murderous zenith in the first half of the 20th century. The postwar European leadership, driven primarily by Germany and France, chose the policy instrument of economic integration "to make future wars impossible." The project has experienced repeated severe crises over its initial half century but each was overcome, indeed giving way to renewed forward momentum for Europe as a whole. The overriding security imperative drove successive generations of political leaders to subordinate their national sovereign interests to the greater good of maintaining, and in fact extending, the European project.

The concept of a common currency was always an element in the region's vision of the ultimate goals of that project. Concrete thinking about an economic and monetary union in Europe goes back to 1970, when the *Werner Report*[2] laid out a detailed three-stage plan for the establishment of EMU by 1980. Members of the European Community would gradually

2. Available at http://aei.pitt.edu/1002/1/monetary_werner_final.pdf.

increase coordination of economic and fiscal policies while reducing exchange-rate fluctuations and finally fixing their currencies irrevocably. The collapse of the Bretton Woods system and the first oil crisis in the early 1970s, however, caused the *Werner Report* proposals to be set aside for a time.

By the mid-1980s, following the creation of the European Monetary System in 1979 and the initiation of Europe's internal market, European policymakers again took up the idea of an economic and monetary union. The *Delors Report*[3] from 1989 envisioned the achievement of EMU by 1999, moving gradually (in three stages) towards closer economic coordination among the EU members with binding constraints on member states' national budgets and a single currency managed by an independent European Central Bank (ECB).

Optimal Currency Area (OCA) theory[4] prescribes the characteristics required for a geographic area to obtain maximum economic benefits from adopting the same currency. It can offer guidance to economically rational leaders about whether it makes sense for their country to join a common currency. But it was not a carefully considered and detailed economic analysis that ultimately led to the creation of the euro. It was geopolitics and the completely unforeseen shock of German reunification in October 1990 that provided the political impetus for the creation of the Maastricht Treaty,[5] which in 1992 laid the legal foundation and detailed design for today's euro area.

With the historical parity in Europe between (West) Germany and France no longer a political and economic reality, French president Francois Mitterrand and German Chancellor Helmut Kohl intensified the EMU process as a political project to complete the integration of the French, German, and other European economies in an economic and monetary union that would accomplish full and irrevocable European unity.

This political imperative for launching the euro by 1999 frequently required that politically necessary compromises, rather than theoretically unambiguous rules, make up the institutional framework for the euro. OCA theory, and the earlier Werner and Delors reports discussing the design of EMU, had been explicit about the requirement to complement a European monetary union with a European economic union complete with binding constraints on member states' behavior. Political realities in Europe, however, made this goal unattainable within the timeframe dictated by political leaders following German reunification.

3. Available at http://aei.pitt.edu/1007/1/monetary_delors.pdf.

4. See Mundell, R. A. 1961. A Theory of Optimum Currency Areas. *American Economic Review* 51 no. 4: 657–665.

5. Available at http://www.eurotreaties.com/maastrichtec.pdf.

Europeans continue to self-identify primarily as residents of their home country.[6] Hence the realization of European federalism, as it is practiced in the United States, is impossible. Consequently, European institutions do not rest on the same degree of direct democratic legitimacy as the US federal government. Crucially, this makes the collection of direct taxes to fund a large centralized European budget (similar to the US federal budget) politically impossible. The relatively high willingness of Europeans to pay taxes does not "extend to Brussels." The designers of the euro area were consequently compelled to create the common currency area without a sizable central fiscal authority that would have the ability to counter region-specific (asymmetric) economic shocks, or re-instill confidence through the deployment of large fiscal resources to private market participants in the midst of a crisis.

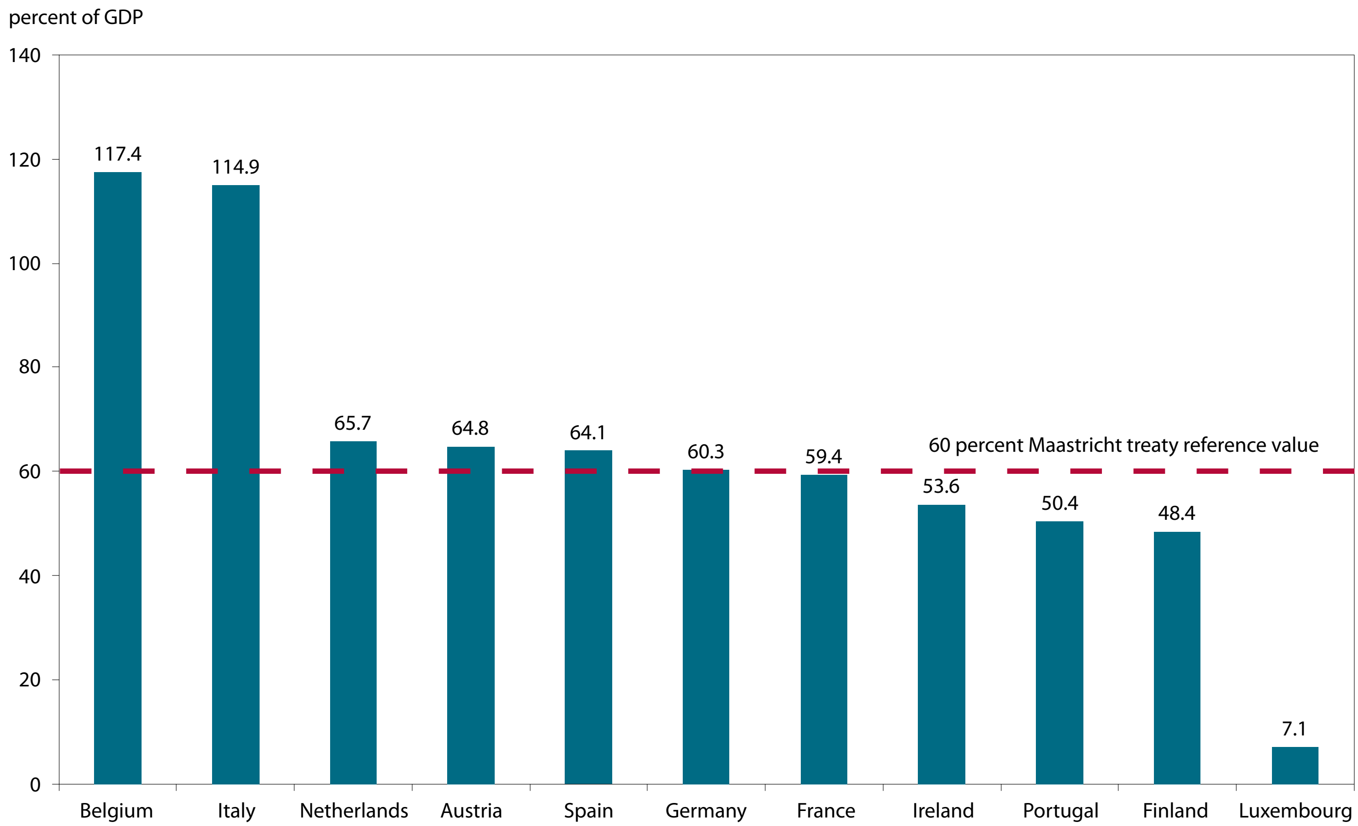
Similarly, the divergence in the economic starting points among the politically prerequisite "founding members" of the euro area made the imposition of firm fiscal criteria for membership in the euro area politically infeasible. The Maastricht Treaty in principle included at least two hard convergence criteria for euro area membership—the 3 percent limit on general government annual deficits and the 60 percent limit on general government gross debt limit.[7] However, in reality, these threshold values were anything but fixed as the Maastricht Treaty Article 104c stated that countries could exceed the 3 percent deficit target if "the ratio has declined substantially and continuously and reached a level that comes close to the reference value" or "excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value." Euro area countries could similarly exceed the 60 percent gross debt target provided that "the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace."

In other words, it was a wholly political decision whether a country could become a member of the euro area or not. Membership was not objectively determined by the fundamental economic strengths and reform record of the country

6. See Kirkegaard, Jacob Funk. 2010. *Will It Be Brussels, Berlin, or Financial Markets that Check Moral Hazard in Europe's Bailout Union? Most Likely the Latter!* PIIE Policy Brief 10-25. Washington: Peterson Institute for International Economics. Available at http://www.piie.com/publications/pb/pb10-25.pdf.

7. The actual numerical reference values to article 104c of the Maastricht Treaty are in a protocol on the Excessive Deficit Procedure to the treaty. Available at http://eurotreaties.com/maatrichtprotocols.pdf. The Maastricht Convergence Criteria for euro area membership eligibility included three other metrics: inflation (within 1.5 percent of the three EU countries with the lowest inflation rate), long-term interest rates (within 2 percent of the three lowest interest rates in the European Union), and exchange-rate fluctuations (participation for two years in the ERM II narrow band of exchange-rate fluctuations).

Figure 1 General government gross debt 1998, 11 original euro area members



Source: Eurostat.

in question. And it was politically inconceivable to launch the euro without Italy, the third largest economy in continental Europe, or Belgium, home of the European capital Brussels. Hence both countries became members despite having gross debt levels of almost twice the Maastricht Treaty reference value of 60 percent in 1997–98 (figure 1).

As a result, Europe's monetary union was launched in 1999 with a set of countries that were far more diverse in their economic fundamentals, and far less economically integrated, than had been envisioned in the earlier Werner and Delors reports or would be dictated by OCA theories. Moreover, shortly after the launch of the euro, European political leaders further undermined the credibility of the rules-based framework for the coordination of national fiscal policies in the euro area.

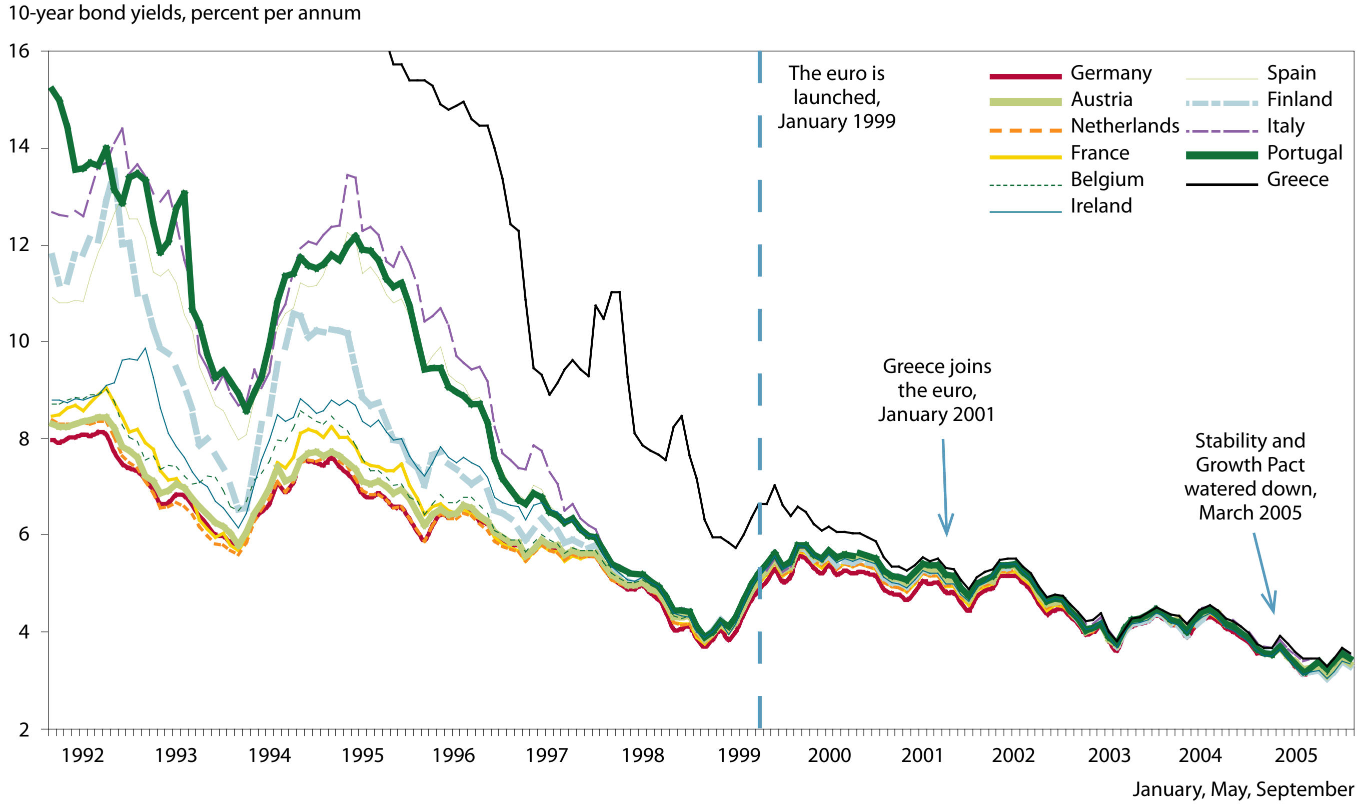
Building on the euro area convergence criteria, the Stability and Growth Pact (SGP) was intended to safeguard sound public finances, prevent individual euro area members from running unsustainable fiscal policies, and thus guard against moral hazard by enforcing budget discipline. However, faced with breaching the 3 percent deficit limit in 2002–04, France and Germany pushed through a watering down of the SGP rules in March 2005[8] that, as in the Maastricht Treaty, introduced sufficient flexibility into the interpretation of SGP that its enforcement became wholly political and with only limited reference to objective economic criteria and data.

In sum, the euro area by 2005 was, as a result of numerous shortcuts taken to achieve and sustain a political goal, a common currency area consisting of a very dissimilar set of countries without a central fiscal authority, without any credible enforcement of budget discipline, and without any real deepening of economic convergence.

Initially, however, none of these fundamental design flaws mattered. The financing costs in private financial markets of

8. See EU Council Conclusions March 23, 2005, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf.

Figure 2 10-year bond rates among euro area members, January 1992–December 2005



Source: Eurostat.

all euro area members quickly fell towards the traditionally low interest rates of Germany (figure 2).

It is beyond the scope of this policy brief to interpret the causes of this colossal and sustained mispricing of credit risk in the euro area sovereign debt markets by private investors in the first years after the introduction of the euro. But the financial effects were obvious: Euro area governments and private investors were able to finance themselves at historically low (often significantly negative real) interest rates seemingly irrespective of their economic fundamentals.

Valéry Giscard d'Estaing, when he was finance minister of France, criticized the "exorbitant privilege" enjoyed by the United States as the issuer of the world's reserve currency, enabling it to pay for imports in its own currency and making it seemingly oblivious to balance of payment constraints. With sudden access to "German interest rates," many new euro area members suddenly enjoyed their own supercharged "exorbitant privilege." Large public and private debt overhangs were correspondingly built up in the euro area in the first years of the new currency and in the run-up to the global financial crisis in 2008.

European policymakers' initial denial and self-congratulations, coupled with financial markets' failure to properly assess the riskiness of different euro area countries and tendency to ignore the common currency's design flaws, thus conspired to ensure that the euro area, when it was finally struck by its first serious financial crisis in 2008–09, was hit by a double whammy of huge pre-crisis public and private debt overhangs and a faulty institutional design that prevented an expeditious solution that would be credible to those same markets.

THE POLITICAL FIGHT BETWEEN THE ECB AND GOVERNMENTS TO SAVE THE EURO

During its first decade, the euro area institutional framework was that of a "fair weather currency." The area entered the Great Recession woefully under-institutionalized as a common currency flying on just one engine—the ECB—but without the unified fiscal entity that traditionally plays a critical role in combating large financial crises. The euro area leaders have had to build their crisis-fighting capacity and bailout institutions (the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM)) from scratch, and in the midst of crisis, to prevent their immediate financial predicament from getting out of control while simultaneously reforming the flawed foundational institutions of the area. Achieving the dual policy goals of solving a current crisis while trying also to prevent the next one—and using the same policy tools to do both—is rarely easy.

During its first decade, the euro area institutional framework was that of a "fair weather currency."

This marks a crucial difference from the United States. Once the Troubled Asset Relief Program (TARP) was finally passed, close collaboration between the multiple existing institutions in the United States (Treasury, Federal Reserve, Federal Deposit Insurance Corporation) ultimately restored market confidence and stabilized the situation in March 2009. In the United States in 2008–09, the economic crisis compelled the Fed to immediately apply the so-called Powell Doctrine—overwhelming firepower—to restore shaken market confidence and give the federal government time to formulate a longer-term response in fits and starts through the TARP. This is a fairly well established crisis response function. The central bank comes out with monetary guns blazing and then sits back and prays that the politicians do the right thing. (Congress did pass TARP after initially rejecting it but has of course not yet chosen to institute a sustainable fiscal response for the United States.)

The ECB, as the only euro area institution capable of affecting financial markets in real time, is a uniquely powerful central bank. Its institutional independence is enshrined in the EU treaty and it is not answerable to any individual government. This has enabled it to function as a fully independent political actor, interacting with elected officials during the crisis in a manner inconceivable among its peers. Quite unlike normal central banks, which always have to worry about losing their institutional independence, in this crisis the ECB has been able to issue direct political demands to euro area leaders—as with the reform ultimatum conveyed to Silvio Berlusconi in August—and demand that they take action accordingly.

On the other hand, the ECB has not had the luxury of adopting the straightforward crisis tactics of the Federal Reserve and the US government within a fixed set of national institutions. The ECB cannot perform a "bridge function" until the proper authorities take over because no euro area fiscal entity exists. Moreover, to commit to a major "bridging monetary stimulus," as some have called for, would undermine chances of a permanent political resolution to the euro area's underlying under-institutionalization problem. Were the ECB to cap governments' financing costs at no more than 5 percent, for instance, euro area politicians would probably never make the painful but essential decisions.

Saddled with administering a common currency, and endowed with governing institutions flawed by early political compromises, it is hardly surprising that the ECB's dominant concern as it manages this crisis has been to prevent "political moral hazard" and not let euro area leaders off the hook. Precisely because Silvio Berlusconi would still be prime minister of Italy if the ECB had purchased unlimited amounts of Italian government bonds at an earlier time, the central bank is highly unlikely to provide the necessary assistance to euro area elected leaders to end the crisis—including the Italian successors of Silvio Berlusconi—unless and until they offer and implement a suitable quid pro quo.

It is imperative to understand that it is not the primary purpose of the ECB, as a political actor, to end market anxieties and thus the euro area crisis as soon as possible. It is instead focused on achieving its priority goals of getting government leaders to fundamentally reform the euro area institutions and structurally overhaul many euro area economies. Frankfurt cannot directly compel democratically elected European leaders to comply with its wishes but it can refuse to implement a "crisis bazooka" and thereby permit the euro area crisis to continue to put pressure on them to act. A famous American politician has said that "no crisis should be wasted" and the ECB is implementing such a strategy resolutely.

So far the ECB has been reasonably effective in this strategic bargaining with euro area governments. It has also consistently been willing to reverse itself when circumstances demanded. The initial Greek crisis in May 2010 led to the first "grand bargain" between the ECB (which agreed to set up the bond purchasing Securities Market Program) and euro area governments. Their agreement produced strong commitments for structural reforms in Spain and elsewhere. It also produced €440 billion in resources for the newly created EFSF, which proved to be an effective euro area fiscal agent when the problem was Greece, Ireland, and Portugal. Again, one must watch what they do rather than solely what they say.

The EFSF is inadequate when the problem becomes Italy and Spain, however. The ECB and euro area governments have therefore for some time been engaged in a new round of strategic bargaining to put together a sufficiently large financial rescue package, secure structural reform of the two big debtors (especially Italy) and, perhaps most importantly, to complete the euro area institutional house. The EU Summit on December 9, 2011 represented the latest round in this game of political poker.

HOW THE DECEMBER 2011 SUMMIT TRIED TO SHIFT THE BAILOUT BILL ONTO SOMEONE ELSE

The real economy in the euro area has gradually deteriorated as regional policymakers dithered in their management of the complex crisis. This rising "economic collateral damage" has increased the pressure to act and led many to speculate that the euro is facing collapse.

This is nonsense. It is abundantly evident that all the key political decision makers in Europe—the ECB, the German government, the French government, Italy, and even Greece—are keenly aware of the catastrophic costs of such an outcome. Greek politicians know that, without the euro and outside the European Union, their country would collapse into a politically vulnerable economic wasteland and/or experience a military coup (the collapse would be far worse than the economic crisis seen since 2009). Angela Merkel knows that, were the euro to collapse, Germany's banks would collapse too under the weight of their losses on loans to the euro-area periphery; the new Deutsche mark would skyrocket, undermining the entire German export economy; and Germany would once again be blamed for destroying Europe. The ECB of course would not want to put itself out of business.

Those political games of chicken are repeatedly being played by all actors to try to extract the best possible deal for themselves. In the end, all will compromise. It is not a coincidence that Greek political leaders, once threatened with expulsion from the euro by Angela Merkel and Nicolas Sarkozy at the G-20 meeting in Cannes, formed the previously elusive national unity government in one week. Italy moved in the same manner within days of its *diktat* from the ECB. Once Germany and the ECB feel they have gotten the best possible deal, or have run out of alternatives, they will pay whatever it takes to hold the euro together. Neither can afford not to. But neither can say so in advance or, at the other extreme, risk seeing their bluff called.

Seen through these lenses, the EU Summit on December 9, 2011 developed in an understandable and promising manner. Two issues were central.

First, after 18 months of accelerating economic crisis, EU leaders finally began detailed political discussions about how to reform the flawed euro area institutions. At German (and implicitly ECB) insistence, the talks focused on a new "fiscal compact" aimed at finally producing for the euro area a set of binding budget rules that will constrain member states' policy in the future. Due to the refusal of the United Kingdom to accept a revision of the existing EU treaty, a new intergovernmental "coalition of the willing" compact will have to be negotiated among a sub-group of the 27 members of the European Union. Substantial legal and institutional uncertainty and "implementation risk" consequently surround these preliminary political decisions and the crucial legal details remain unfinalized. Yet the fact that 26 (or even 23) European heads of state and government declared their political intention to enter into a new fiscal compact, which will severely constrain their future fiscal sovereignty, is testament to the unflinching will to do whatever it takes to save the euro.

Many were disappointed by this narrow agenda and the lack of discussion of a larger centralized EU budget, like in the United States, or the immediate creation of joint eurobonds. However, it must be recalled that, as discussed earlier, Europe does not have the democratic legitimacy to collect taxes for a centralized budget at this point. Similarly, Europe lacks the compelling "endured in a common cause" (i.e., the Revolutionary War) political narrative that enabled Alexander Hamilton to pool together the debts of individual US states into common Treasury bills and bonds. Italy's debts have been run up to benefit Italians and other European taxpayers will surely revolt if suddenly compelled to pay part of them.

The reality in the euro area is that, for the foreseeable future and unlike in the United States, the overwhelming majority of government taxation and spending will continue to reside at the member state level for reasons of political legitimacy. Only a minor part will be pooled at the supra-national level. Restricting this spending via a new fiscal compact is consequently the only pragmatic route for now, leaving other aspects of euro area fiscal integration to the future.

Second, EU leaders tried to thrash out a sufficiently large financial firewall to restore confidence in the solvency of Italy and Spain. This issue was addressed in several ways. For one, euro area leaders reversed their initial intent to insert Private Sector Involvement (PSI) clauses into the new permanent ESM treaty. This should make it clear that private sovereign bond market investors face the same legal environment in the euro area as elsewhere, making the case for "Greece being a unique case" legally and politically more credible. This should ultimately help restore fleeting investor confidence in euro area sovereign bonds. In the grand game of distributing the costs of the euro area bailouts, private investors will not be asked to take haircuts other than in Greece in the hope they will then lend new money to the other debtor countries as the latter undertake the needed adjustments.

EU leaders further continued their sparring about the ultimate distribution of the costs of extending the euro area financial rescue by pledging €200 billion (€150 billion from the euro area) in new general resources to the International Monetary Fund (IMF). This would come in the form of loans from EU central banks[9] with the political understanding that the resources would be utilized predominantly to stabilize Italy and Spain. This attempt to involve the IMF directly in the rescue of the two larger euro area economies is in many ways reminiscent of the two-thirds/one-third financing split between the euro area and the rest of the world (as shareholders of the IMF[10]) for the existing IMF programs for Greece, Ireland, and Portugal.

However, given the better economic fundamentals in Italy and Spain and the prohibitively high costs of extending to them the type of traditional IMF programs granted to the three smaller euro area economies, a less politically intrusive and less expensive vehicle for IMF involvement may be found. This will still presumably entail special IMF borrowing from surplus and creditor countries around the world. A number have already said they will participate in such an initiative: Brazil, new G-20 chair Mexico, Russia, and a number of non-euro Europeans. China and other large Asian holders of foreign exchange have been more coy. They have also clearly indicated a desire to diversify their huge reserves away from dollars, however, so new claims on the IMF would presumably look quite attractive to them from a purely financial management point of view.

Total IMF borrowing, and the creation of a "firewall" to insure against default by major euro area countries, should and probably will exceed €1 trillion. Taken in combination with the €500 billion in the EFSF/ESM, the €700 billion or more from the ECB from its previous programs (€211 billion in sovereign bond purchases through the Securities Markets Programme (SMP), €489 billion in three-year loans[11]), and its essentially unlimited liquidity provisions to the euro area banking system, this amount should convince even the most skeptical market participants that the "firewall" is adequate even for Italy and Spain.

In now turning to the IMF, the euro area leaders acknowledge that their previous "euro area governments only" EFSF bailout vehicle will not be an efficient mechanism through which to provide assistance to Italy and Spain. While this may seem like a political setback, going through the IMF rather than the (leveraged) EFSF in fact provides the euro area with significant credit enhancement because it makes it much more likely that other IMF member governments, e.g., China and other surplus countries, will choose to contribute.

In that way the IMF will quite likely serve as a far better leverage mechanism for the euro area's own resources (€150 billion) than had this money instead simply been added to the EFSF itself.[12] Euro area governments will have successfully shifted part of the costs of any future financial rescues onto the rest of the world. The rest of the world will of course extract a suitable price from the euro area for this service in the form of European political concessions in other policy areas. This could, for instance, be a good time to demand that the euro area consolidate its representation on the IMF board to a single seat and accelerate the transfer of its quota shares to the financially contributing emerging markets.

Recent ECB policies have similarly tried to shift the bailout cost to other entities. In his December 1, 2011 testimony before the EU Parliament Mario Draghi famously stated "We might be asked whether a new fiscal compact would be enough to stabilize markets and how a credible longer term vision can be helpful in the short term. Our answer is that it is definitely the most important element to start restoring credibility. Other elements might follow, but the sequencing matters."[13] This was immediately taken by markets to mean that, provided EU leaders agree on a new "fiscal compact," the ECB would be willing to step up its sovereign bond market interventions and largely pick up the tab for bailing out Italy and Spain.

Unsurprisingly, euro area bond markets rallied strongly in the expectation of an official sector bailout from the ECB until the next Mario Draghi press conference on December 8, 2011, when he walked back his earlier comments by stating in response to a question that: "The purpose of the SMP is to reactivate the transmission channels of monetary policy. As I said in the statement to the European Parliament, the SMP is neither eternal nor infinite. We must keep this in mind and we do not want to circumvent Article 123 of the treaty, which prohibits the monetary financing of governments… the need to respect the spirit of the treaty should always be present in

9. Note that this means that any loans made to the IMF by euro area central banks will expand the consolidated European System of Central Banks' (ESCB) balance sheet, even if the loans are not disbursed by the ECB itself.

10. The two-thirds/one-third breakdown is not entirely accurate, as the euro area members are sizable shareholders of the IMF themselves and hence in total contribute more than two-thirds of the total financing of these programs.

11. One might arguably also add the two ECB-covered bond purchase programs (~€62 billion) with unlimited liquidity of less than a three-year duration to these central bank support measures.

12. Routing euro area central bank loans through the IMF general resources also provides governments a better "legal fig-leaf" against political charges of "monetary financing" (voiced by, for instance, the German Bundesbank) than if such loans had been used to leverage the EFSF directly.

13. Available at http://www.ecb.int/ press/key/date/2011/html/sp111201.en.html.

our minds."[14] Hence the ECB would not be willing to proactively bail out private investors in the Italian and Spanish debt markets. Those markets fell dramatically on the very day of the EU Summit.

The ECB signal thus sent to EU leaders ahead of their summit seemed unambiguous: It is up to the fiscal authorities, not the monetary authorities, to pay to restore market confidence in the Italian and Spanish bond markets. By turning to the IMF at their summit, euro area leaders indicated that they had clearly gotten the message.

The ECB refused to intervene directly and more forcefully in the euro area sovereign bond markets on December 8, 2011. But the central bank did effectively bail out the entire EU banking system, and with it many of the private sovereign bond creditors, through a series of additional enhanced credit support measures to support bank lending and liquidity in the euro area. These included unlimited liquidity provisions for three years, compared to a previous maximum of one year, expanded ECB collateral eligibility to include bank loans, and cutting the reserve ratio in half to 1 percent.[15]

These forceful ECB liquidity measures were clearly warranted given the stress in the inter-bank credit markets in the euro area. However, they also provide a potential back door for euro area banks to use some of the funding available from the ECB to purchase additional euro area sovereign bonds and thereby stabilize markets. In this way, assuming that euro area banks can be morally swayed to make such purchases, the ECB would indirectly provide the financing for private banks to support the euro area sovereigns. This would constitute a below-the-radar bailout of governments by the ECB through the private banking system with the political benefits to the central bank that it does not violate the EU treaty ban on monetary financing.

In summary, the December 9, 2011 EU Summit shows how the key actors in the euro area crisis are still positioning themselves to force others to pick up as much of the costs of the euro area crisis as possible. In the meantime, the crisis continues and may superficially appear to be insoluble. There are in fact several possible solutions to stave off a near term meltdown, however, when Italy and Spain begin their large bond rollovers in early 2012:

- Germany can write a check and agree to expand the EFSF/ESM and/or give it a banking license.
- The IMF can write a check using new resources from the euro area and rest of the world to put together a sizable new support program for Italy and/or Spain.
- The ECB can write a check and begin to purchase much larger amounts of the relevant sovereign bonds.

It remains to be seen which solution will ultimately be chosen. It is possible, indeed likely, that the ultimate package will combine parts of each of the above. But it is obvious that none of these solutions are even remotely as costly for any of the main actors involved, inside or outside the euro area, as a sovereign default in Italy and/or collapse of the euro. That is why, once the political pre-positioning is over and the alternatives are exhausted, the games of chicken will end and the political decision on how to split the bill for securing the euro's survival will be made.

THE REMAINING AGENDA

Even the most successful financial engineering in the euro area will ultimately fail, however, if the debtor countries, and indeed the region as a whole, are unable to restore at least modest economic growth in the fairly near future. This requires at least three major steps:

- The borrowing countries must adopt convincing pro-growth structural reforms, especially in their labor markets, as well as budgetary austerity.
- The strong economies in the northern core of Europe, especially Germany, must terminate their own fiscal consolidations for a while and adopt new expansionary measures, i.e., they should buy more Italian and Greek goods and services rather than debt instruments.
- The ECB must promptly reduce its policy interest rate by at least another 50 basis points and buy sufficient amounts of periphery bonds through the SMP to help push their interest rates down to sustainable levels.

There has been much talk about the infeasibility of achieving the needed "internal devaluations" of the periphery countries. Germany has achieved just such an adjustment over the past two decades, however, probably amounting to about 20 percent of the (overvalued) exchange rate at which it entered the ERM/euro, through a combination of budget tightening and structural changes like the Hartz labor reforms. At the other end of the size spectrum, Latvia achieved an even speedier and more spectacular correction of its huge current account deficit of 25 percent of GDP and, only three years later, is now combining renewed growth with an external

14. Available at http://www.ecb.int/ press/pressconf/2011/html/is111208.en.html.

15. Available at http://www.ecb.int/ press/pr/date/2011/html/pr111208_1.en.html.

surplus. Italy has previously achieved dramatic adjustment, notably to qualify for the euro in the first place. (Greece never did so and its ability to remain within the zone is clearly more problematic.)

The agenda for the euro area, and indeed Europe more broadly, thus ranges well beyond the financial engineering that is clearly the most urgent requirement to overcome the crisis. Both the history of the integration project and the revealed responses at each stage of the current turmoil, however, suggest that both the historical imperatives and economic self-interest of all the key countries, both creditor and debtor, will coalesce successfully. Watch what they do rather than what they say as the drama continues to unfold.

The final major political challenge on the euro area agenda for 2012 goes beyond measures to address the immediate crisis but rather focuses on the longer-term continuation and direction of euro area institutional reform. During 2012, the euro area is likely to adopt a new and considerably more credible set of fiscal rules and budget oversight regulation. This has been a clear demand from both the ECB and Germany. But while the new fiscal compact will undoubtedly help stabilize the euro area in the future, it must be thought of as merely a beginning of the institutional reforms needed in the region. Fiscal consolidation is not everything and the movement toward further and symmetrical deepening of euro area fiscal integration must be maintained. Following the "fiscal rules first" down payment, euro area leaders must consequently take further concrete steps in 2012 on a reasonable timetable toward the introduction of measures such as eurobonds.

It took ten years for the first serious economic and political crisis to arrive after the euro was introduced. The most challenging part of today's crisis is to use the political opportunity it presents to get the basic economic institutions right and complete the euro's half built house for the long term. In this process the euro will develop in a different manner from the full economic and monetary union established in the United States. It will require additional substantial treaty and institutional revisions in the future. But as the US Constitution's 27 current amendments clearly show, faulty initial designs need not preclude long-term success. If the history of the integration exercise and its crisis responses to date are any guide, Europe will emerge from its current turmoil not only with the euro intact but with far stronger institutions and economic prospects for the future.