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The Euro's Never-Ending Crisis

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The 2010–11 euro crisis has been far and away the gravest challenge that the single currency has faced since it was created in 1999. But understanding how euro zone countries can get out of the crisis first requires understanding how they got into it.

In Greece, the proximate cause of the crisis was enormous, unsustainable government budget deficits that were disguised through manipulation of the public accounts, and even worse devices, until the socialist government of George Papandreou entered office in 2009. In Ireland, the problem was a gigantic property bubble, even dwarfing the real estate bubble in the United States, which brought down banks when it burst. This led the Irish government, in its wisdom, to guarantee the liabilities of the country's financial institutions, which in turn severely damaged the sovereign's own creditworthiness. In Portugal, the problem was a sclerotic economy in which productivity failed to grow.

Differing diagnoses suggest differing remedies. Greece needs stronger fiscal rules and oversight. Ireland needs stricter regulation of its financial system so that banks do not again become overexposed to the property sector. Portugal needs structural reforms to help productivity grow. But exactly how the European Union should respond, beyond encouraging member states to tend to their gardens, remains unclear.

SAME BUT DIFFERENT

To assess potential EU responses, it helps to identify common elements in Europe's crises. These can be found in enormous credit booms in Ireland and in Greece, Portugal, and other southern European countries.

Beginning around 2002, consumer credit grew significantly faster in Ireland, Greece, Portugal, Spain, and Italy than in Germany, France, and the other countries of the euro-area "core." Households borrowed from local banks, which in turn borrowed from banks elsewhere in Europe. In other words, banks in the problem countries "funded" their loans not only by accepting deposits from residents but also by borrowing on the interbank market. As a result, massive amounts of capital flowed from France, Germany, and the other core countries to Ireland and southern Europe.

The various capital-importing nations put their borrowed funds to different uses. Portuguese households went on a consumption binge. Their Irish counterparts plowed the money into McMansions. Elsewhere, these excesses manifested themselves in yet other ways. But the proximate cause—a credit boom financed by foreign capital—was the same.

The question is whether these credit booms were caused by the euro. The answer is not clear. For one thing, the United Kingdom, outside the euro area, also had an enormous credit boom. British banks, typified by Northern Rock, borrowed on the interbank market, ramped up their ratio of loans to capital, and fueled a housing bubble. Iceland, also outside the euro area, had an enormous credit boom culminating in the mother of all banking crises.

Not least, the United States had a credit boom of its own, in which banks and nonbank financial institutions used loans and securitization to funnel finance into the private sector, inflating a housing bubble and allowing households to incur additional debt. And although Ireland, Greece, Portugal, Spain, and Italy imported large amounts

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of capital and ran large current account deficits in the years leading up to the crisis, America's current account deficits and dependence on foreign capital were every bit as large.

This suggests that other factors in addition to the euro—from investor nonchalance to regulatory failure—aggravated the problem. However, while the United States had been running substantial current account deficits for decades, the same was not true of Ireland and southern Europe. Those countries' deficits, and the capital inflows that supported their credit and consumption booms, expanded noticeably with the advent of the euro.

QUELLE SURPRISE

Why should the creation of the single currency have caused imbalances within the euro area to widen?

Long before the euro was adopted, many had argued that finance should flow from the capital-abundant, high-income countries of the European core to the capital-scarce, low-income countries of the periphery. In this second set of countries, investment opportunities were abundant and there was scope for rapid catch-up growth to close the per-capita income gap. European technocrats even coined a name for this process of income evening: cohesion.

The problem was that for a variety of reasons—such as unstable public finances in the periphery countries and fears that governments might devalue their currencies—the capital that the catch-up economies needed to finance investment was not forthcoming.

The euro, it was thought, would do away with these obstacles. It would eliminate the easy option of devaluation. National central banks would no longer be able to print money to finance their governments' budget deficits. Fiscal authorities would be subject to the disciplines of the EU's Stability and Growth Pact, preventing them from running excessive deficits. And if imbalances in the euro area now widened, the conclusion followed, these were "good imbalances" indicating that capital was now finally flowing toward countries where the productivity of additional investment was highest.

We now know that this faith in "good imbalances" was misplaced. Output and productivity differentials between Europe's core and periphery, rather than converging, diverged further in the first decade of the euro. It was Germany, not Portugal or Greece, that experienced an export boom and a surge in labor productivity.

The reasons that the countries of the periphery failed to keep up are straightforward in retrospect. Foreign capital financed not more investment in plant and equipment, which would have boosted output and productivity, but more consumption (including but not limited to more consumption of housing services). Firms enjoying strong demand for locally produced goods and services could accede to their workers' demands for higher wages. Governments, seeing receipts for value-added taxes growing along with the consumption boom and income tax revenues rising along with citizens' wages, felt comfortable granting public-sector unions' demands. And the Stability and Growth Pact, along with the discipline it would supposedly confer on federal budgets, was honored mainly in the breach.

The subsequent problems should not have come as a surprise. Certain observers, like the Franco-American economist Olivier Blanchard—then a professor at the Massachusetts Institute of Technology and currently chief economist at the IMF—were sounding the warning bell already in 2002. Yet even the Cassandras did not foresee the gravity of the risks. Others, meanwhile, remained blissfully unaware. The investment would come, the governments of southern Europe murmured. The productivity boom was in the making, they insisted.

It is of course in the nature of financial markets to take such assertions at face value. Nothing about this is distinctly European. Precisely the same tendency to underestimate risk prevailed in the United States, as has been learned at considerable cost.

With the outbreak of the global financial crisis, previously sanguine investors became hyper risk-averse. The euro-area periphery, which formerly escaped serious scrutiny, came under the microscope. Financial imbalances became more difficult to finance. The banks of the euro-area core, desperately deleveraging, became more reluctant to lend. In the countries of the European periphery, accumulated imbalances came onto governments' balance sheets.

In Greece, of course, that is where the imbalances had always been, though that fact was long hidden through specious budgetary arithmetic. In Ireland, the authorities provided guarantees to, and injected capital into, a banking system that otherwise would have lost access to funding. The cost of the Irish bank bailout was 20 percent of GDP in 2010, with more still to come, as further losses are realized on loans and investments in the property market.

Looking back, we see that governments should have reined in the banks to restrain the growth of consumption and the boom in property prices. As protection against a rainy day, they should have run larger budget surpluses while the sun was shining. Of course, these are the same things that the United States should have done in the first half of the past decade. In other words, the crisis in Europe reflects European failings, but not uniquely European failings.

EMERGENCY MEASURES

When the crisis erupted, the immediate task was containment: to stanch the bleeding in the countries of the euro-area periphery and prevent the infection from spreading. The process began with Greece. As the depth of that country's fiscal problems became clear in early 2010 and doubts mounted about the sovereign's solvency, the prices of Greek bonds plummeted. The Papandreou government sought to reassure investors by introducing spending cuts and revenue enhancements, the latter mainly composed of efforts to reduce tax evasion.

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In a parliamentary democracy, however, such measures must be debated, and adoption is not guaranteed. There was resistance from those who saw their personal ox as being gored. There was the danger that the government would fall, halting fiscal consolidation in its tracks.

The EU therefore agreed in May 2010 to cooperate with the IMF in extending Athens an emergency loan of 110 billion euros. The money came partly from the European Commission, which had an odd 60 billion euros lying around. The IMF chipped in its part. The balance, along with funds for any additional bailouts that might become necessary, was supplied by the European Financial Stability Facility (EFSF), a body created by the EU member states to sell bonds guaranteed by the financially strong member states—in effect, by those countries' taxpayers.

The plan permitted Greece's adjustments to be spread out over several years, limiting the danger of populist backlash. The IMF described a scenario in which growth would resume after a couple of difficult years and the budget deficit would be gradually eliminated, with public debt topping out at some 150 percent of GDP. The IMF, together with Greece's EU partners, negotiated deficit reductions and other reforms that Athens would have to implement.

Taxpayers, in Germany and elsewhere, were understandably riled. Their leaders, knowing on which side their bread was buttered, expressed their own reluctance to support a "taxpayer-financed bailout" of their profligate neighbors. The result was posturing and brinkmanship, which only further roiled the markets.

Three factors compelled the opponents of the rescue fund to back down. First, there was EU solidarity—the sense that European countries were in this battle together. Second, there was fear of the unknown. If Greece was not helped, the implications for other countries, the single currency, and the European project were not good. Might the crisis spread to other countries? Might Greece reintroduce the drachma in an effort to restore its economy's competitiveness? Might other countries follow suit, shattering the monetary union?

The third consideration, and surely the most important, was the impact that the Greek crisis might have on the banking systems of other European countries. Before the crisis, banks had loaded up with debt issued by Greece and other countries on the European periphery. If Greece halted interest payments on those bonds, and failed to redeem them when they matured, the damage to the banks could have been severe. (Actually, the potential consequences were disputed, but with European governments and regulators not having performed proper stress tests on the banks, the uncertainty itself could have had severely adverse consequences for the banks' ability to fund their operations.)

It was on this issue that the decision to proceed with the bailout turned. The Greek rescue reflected the self-interest of the rescuers, not their magnanimity.

THE HOLIDAY ENDS

The markets, exhausted by all the excitement, then settled down. Or they may have settled down mainly because much of Europe was on vacation from mid-July to late August. In any case, in September 2010 volatility returned with a vengeance. With Greek GDP growing more slowly than had been projected when the program with the IMF and the EU was negotiated, Athens's tax revenues lagged. Yet again, the government's deficit figures had to be revised upward.

The Irish government, meanwhile, was forced to acknowledge that its budget deficit for 2010, instead of an alarming 12 percent of GDP, would be a horrifying 32 percent, reflecting Dublin's efforts to fill the enormous hole in the banks' balance sheets. To reassure investors that it had the wherewithal to shoulder this bill, the government was forced to produce another round of deep spending cuts.

Ireland, unlike Greece, faced no immediate need to borrow. Its government, having husbanded cash, did not have to return to the bond markets until the middle of 2011. The country's banks, however, continuously needed to borrow. They funded their operations by borrowing depositors' money and by borrowing from other banks on the wholesale money market.

In November 2010, as creditors grew skittish about the government's capacity to honor its guarantee of the banks' liabilities, both sources of funding dried up. Increasingly, Irish banks were reduced to borrowing from the European Central Bank (ECB). By lending to them, the ECB buttressed the stability of Europe's payments system and prevented the panic from spreading. But it also exposed itself to the risk of financial losses.

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Other EU countries therefore applied pressure on Ireland to regularize this irregular situation—in effect, to get the ECB off the hook. In November they pressed Ireland to negotiate a Greek-style loan from the IMF and the EFSF.

The Irish government resisted, since it had no immediate need to borrow. As for supporting the banks, it naturally preferred the status quo, according to which liquidity was provided by the ECB. But a small island off the northwest coast of Europe could hardly hold out against an entire continent, especially when the ECB was signaling that it might withdraw support for the banks at any time.

RELUCTANT TO RESTRUCTURE

In Ireland, as in Greece, the IMF forecast that public debt would top out well in excess of 100 percent of GDP, even if everything went according to plan. At the point that the debt-to-GDP ratio peaked, Ireland would be transferring close to 10 percent of its GDP per anum to the creditors, many of whom were foreign. At a time when everyone else was seeing their incomes decline—Irish GDP fell by 17 percent between 2008 and 2010—privileging the bondholders might turn out to be politically untenable.

It may also turn out to be economically untenable. In order for debt repayments to be maintained, taxes will have to increase further, which will discourage the investment needed for growth to resume. (This is the problem of "debt overhang," familiar from Latin America in the 1980s.) Meanwhile, deeper public spending cuts will only weaken growth and domestic demand still further. And with no national currency to depreciate, there is no easy way to substitute export demand for the domestic demand that is being compressed.

Why, then, was the Irish government—along with the governments of other crisis countries—reluctant to contemplate restructuring its debts? Governments could have acknowledged that paying in full was economically and politically untenable. They could have opened discussions with their creditors and formulated an exchange offer, allowing bondholders to choose from a menu of new bonds that featured longer maturities, lower rates of interest, or smaller principal. In this way they could have begun to put the crisis behind them.

Governments, however, are always reluctant to go down this road. Debt restructuring, from their perspective, alienates investors and puts capital markets out of reach. Local investors hold some portion of the debt too, so a domestic constituency opposes restructuring. And in Europe, where the wishes of EU partners matter, it is significant that debt write-downs might damage neighbors' banks.

Nevertheless, if restructuring is unavoidable, it is better to get it out of the way. Removing the debt overhang would permit growth to resume sooner rather than later. Meanwhile, if other EU countries had grounds for concern about the impact of debt restructuring on their banking systems, they could have used a portion of the funds deployed to keep Greece and Ireland afloat to inject capital instead into French, German, and Belgian banks.

This approach, however, would have required the governments of core Europe to abandon their pretense that the money they had stumped up to defuse the crisis would be repaid in full—not an easy pretense to abandon.

BEYOND COSMETICS

The fact that resolving the crisis will be costly has one silver lining. It concentrates attention on the need to reform the institutions of the euro area to prevent equally costly crises from occurring again.

A first obvious need is to strengthen fiscal discipline. Indeed, it is all but obligatory for observers of the EU to call for strengthening the Stability and Growth Pact, through which the EU oversees the fiscal policies of member states and putatively subjects chronic violators to sanctions and fines. To strengthen and integrate budgetary surveillance, governments have now agreed to synchronize the submission and assessment of their national fiscal plans. Also, whereas in the past the European Commission's recommendations to impose sanctions against violators required a vote of support by a qualified majority of countries, now such a recommendation will stand unless a qualified majority overturns it.

That said, one worries that these changes are merely cosmetic. The EU's record of enforcing the Stability and Growth Pact is not heartening. Countries will still be tempted to spare violators from sanctions out of fear that they themselves may become the targets of similar sanctions in the future. And ultimately, nothing can substitute for strengthening fiscal institutions and procedures at the national level.

Countries like Greece, for example, could enhance the transparency of their budgetary accounts. They could establish fiscal councils of outside experts, as in Sweden, to provide independent forecasts of revenue and spending. Prime ministers and finance ministers could be given more agenda-setting power over budgetary negotiations. Where this is problematic, legislators could adopt explicit fiscal rules, like a measure adopted in 2006 in Germany designed to limit that country's structural deficit to 0.35 percent of GDP. The European Commission and the other organs of the EU should encourage member states to move in these directions.

A second obvious need is to strengthen Europe's banks. This effort must start with meaningful stress tests (assessing whether banks have enough capital to withstand difficult economic conditions). Such tests should extend to scenarios in which sovereign debts are restructured. Where banks' capital is insufficient, they should be required to raise more immediately. If this is impossible, they should be taken over by the authorities and either recapitalized with public funds or closed down.

Here again, the record is not heartening. National governments seem more concerned with preventing their banks from losing market share than with determining the institutions' actual financial condition. Thus, meaningful stress tests will require taking the process out of national hands and delegating it to a fair broker like the European Commission.

The argument for doing this is strong. Europe as a whole has a stake in the prudential policies of its individual members. Its national banking systems are deeply integrated as a result of the single market. The Irish crisis is a graphic reminder of how problems in one national banking system can spill over to other countries.

This means that delegating the supervision and regulation of financial institutions to home-country authorities will not suffice. If Europe has a single currency and a single financial market, it is going to need a single bank regulator. Admittedly, financial institutions often serve political purposes, making their regulation a jealously guarded national prerogative. But this prerogative has outlived its usefulness.

Next, Europe needs a permanent emergency financing facility. Crises will happen. Governments will lose access to financial markets for a time. In such instances, their partners in the EU will have to provide them with temporary assistance. Not establishing a properly funded facility capable of providing emergency assistance is the macroeconomic equivalent of driving without a seat belt.

At a summit in December 2010, European leaders agreed to create a permanent successor to the EFSF once it expires in 2013. But aside from giving the entity an impressive new name, the European Stability Mechanism (ESM), the leaders provided few details—presumably because they had not decided on them.

The one detail on which they did agree, at German insistence, was that the ESM would lend only at penalty rates and assist only governments that have passed a "rigorous debt sustainability analysis." These provisions were designed to enable those in charge of the ESM to say "no," and thereby to prevent the mechanism from becoming an engine of moral hazard. They were also designed to reassure German taxpayers that the ESM would not develop into a vehicle for ongoing transfers from the EU core to the EU periphery.

This same logic points to the need to establish an alternative for governments whose debts are unsustainable. To this end, European leaders agreed that all future government bonds would include "collective action clauses" designed to make restructuring easier.

But making restructuring easier will also make borrowing harder for governments whose debts are borderline sustainable. Even if countries like Greece and Ireland manage to make it financially to 2013, they will almost certainly experience a funding crisis then. Potential purchasers of government bonds, anticipating the possibility of restructuring—even a limited possibility—will go on strike.

MAKE A CHOICE, OR ELSE

In other words, EU leaders have created an impossible situation. They cannot delay unpleasant decisions indefinitely; they will have to choose between two unsavory alternatives. On one hand, they can allow countries like Greece and Ireland to write down their already heavy debts. Debt burdens will then become sustainable, and governments will be able to play by the new, more demanding rules starting in 2013. This will also mean losses for banks in creditor countries and corresponding injections of public capital, a prospect that does not appeal to decision makers.

On the other hand, the EU can relax the rules governing ESM loans after 2013. It can authorize the ESM to lend more freely at concessional interest rates. It can back away from the introduction of collective action clauses and from the idea that problem debts should be restructured. Indeed, to give countries like Greece and Ireland a fighting chance of getting to 2013, the EU will have to reduce the 6 percent interest rate in the existing rescue packages.

Another way of achieving the same goal would be to authorize the ESM to issue E-bonds—bonds backed by the full faith and credit of the entire group of EU member states, including Germany—and allow troubled members like Greece and Ireland to exchange their existing sovereign debt for E-bonds up to some limit (say, 60 percent of GDP).

This would effectively constitute a financial transfer to the crisis countries from Germany and the other members of the EU core. It would, in effect, be the first step toward a fiscal union in which transfers from rich to poor EU countries were ongoing. Again, this is not something that will appeal to decision makers in Germany and the other countries of core Europe.

Both choices are unappealing, but this does not relieve European leaders of having to choose. Pretending that some third, imaginary alternative also exists will only allow the crisis to fester. If European leaders continue to deny reality, they heighten the danger that the crisis will ultimately blow up in their faces. More banks will fail. The financial systems of yet more countries will be engulfed. Not just the euro but the EU itself could be at risk. European leaders have the capacity to avoid all this. They just need to display the will. ■