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The Eurozone's Arrested Adolescence: Sketching a Way Out of the Crisis

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Gentlemen, we have run out of money. It is time to start thinking.

Sir Ernest Rutherford[1]

A COMMITTEE IS a group that keeps minutes and loses hours, someone once quipped. It is certainly tempting, although a bit unfair, to draw a parallel to the Eurozone's committee-led struggle against its crisis and the growing distrust in its leadership's ability to keep the fledgling currency union together. Hours, weeks, months and now years have been lost since the first bailout package to Greece was put together in May 2010. The economic sources of the Eurozone crisis would have been difficult for any government to address. But the crisis on the continent has been reinforced and prolonged by leaders' inability to agree on robust and credible crisis responses. Individual

SUMMARY

The Eurozone crisis has been reinforced and prolonged by leaders' inability to agree on robust and credible crisis responses. Individual governments are experiencing sovereign deficit and debt crises, but not the Eurozone at large. Its fiscal position is manageable. The Eurozone is rather going through a *crisis of the sovereign – or a crisis of government.* Too many of the crisis solutions offered by Eurozone leaders have commanded neither authority nor electoral legitimacy.

At the heart of the Eurozone crisis is the quest for ultimate responsibility: at which point is responsibility no longer passed on to others? Or as Harry Truman would have phrased it: where does the buck stops? What markets need to know is: if the euro system is getting close to its breaking point, will anyone step in to stop it form breaking apart? Arguably, there is only one actor in Europe with pockets deep enough to offer such a systemic guarantee for the Eurozone. And it is not Germany. In fact, it is delusory to think that Germany, or any other government, has the economic and political capacity to give the systemic guarantee of the euro's survival that is now absent. No, that actor is the European Central Bank.

Much needs to change for the Eurozone to get out of the crisis. But it must start with a clearer role of the ECB as a lender of last resort to sovereigns. Other measures to support distressed governments are necessary, but they cannot substitute the ECB. The bailout funds will not be able to get as much capital that is necessary to calm markets. And Eurobonds or other larger projects to mutualise accumulated debt are unlikely to be the solution to the current crisis. Eurobonds may be established in the future, but not before the current debt crisis been resolved. The pace of fiscal adjustment needs to slow down in some countries – and, more generally, crisis responses must be more sensitive to the sources of economics problem and where countries are in the recovery cycle. Importantly, structural economic reforms, pushing medium-term economic growth, are necessary to avoid long processes of fiscal adjustments.

governments are experiencing sovereign deficit and debt crises, but not the Eurozone at large. Its fiscal position is manageable. The Eurozone is rather going through a *crisis of the sovereign* – or a crisis of government. Too many of the crisis solutions offered by Eurozone leaders have commanded neither authority nor electoral legitimacy.[2]

Umpteenth crisis summits have produced compromises and communiqués that have fudged on the critical issues. The analysis of the economic problems, has been selective and professed solutions have, at best, been piecemeal. Inconclusive responses have fed what economist Willem Buiter has called the markets "self-fulfilling fear equilibrium belief" in the Eurozone. Crisis responses by both fiscal and monetary policy leaders have failed to convince markets and the outside world to move out of this danger zone. Worse still, some of the crisis responses have done more harm than good, sparking deeper distrust rather than confidence.

To blame it all on incompetence, as some do, is tantalizing but deceiving. It is true that key leaders and authorities were slow to understand the severity of the crisis. And some of them have used the crisis to propagate their own predilections for either deeper or weaker economic European cooperation rather than addressing the causes of the crisis. Yet if the crisis had its roots in incompetence, it would have been easy to fix. The problem now is not one of information but motivation. And this is what makes the crisis in some countries so destabilising for the entire Eurozone. The Eurozone is fractured by profoundly opposing views about the course of economic policy and what institutional change that is necessary for the euro cooperation to survive in the next year. And these opposing views reflect economic philosophies and economic-policy cultures that look incompatible.

The discussion over Eurobonds is a case in point. Many countries, and the Brussels' institutions, have hassled Germany to drop its opposition to Eurobonds. But Germany's resistance to pooling liability for already accumulated debt is only one side of the debate. Those that have been calling for a "Hamilton moment" in Europe have conveniently forgotten that there would not have been a Hamiltonian federalisation of debt in the U.S. without James Madison and the constitutionalisation of America.[3] And it is equally true today that mutualisation of debt has profound political and constitutional consequences. Under the assumption – unlikely in my view – that Germany would concede to Eurobonds in the short term, it would inarguably condition its support on the establishment of a political or fiscal union that would involve a drastic loss of fiscal (and political) sovereignty, especially for those that in the German view are "sinners" or that do not comply with the established fiscal-policy rules. And few other governments could really accept that quid pro quo. France has resisted that German demand ever since the idea of a common monetary system was floated in the 1970s.[4] While it looks feasible in the abstract – other countries get support from Germany in exchange for embracing German *Ordnungspolitik* – no side in the debate has shown readiness to accept what is required to get it done.

The risk of a Eurozone collapse is increasing rapidly. There are no quick fixes, no easy ways to reverse the current course of the euro ship. The Eurozone will have to spend the rest of this decade, if not longer, to correct past mistakes. It is highly likely that the composition of the Euro will look different five or ten years from now. Exactly how it will be structured, or which countries that will remain members, is impossible to say now. What is clear, however, is the need for policy changes in the short term for the Eurozone to move out of the danger zone and create a less distressing economic and political atmosphere for the long period of fiscal and economic adjustments that inevitably must happen in many countries. This paper aims to outline these necessary policy changes. Hence, the paper is more concerned with the political economy of the crisis, and of European cooperation, rather than the economics of the crisis.

Eurozone leaders are now preparing to rehabilitate the institutional structure of the Eurozone. It may be a useful exercise, but it will hardly be the turning point in the current crisis. There are many institutional reforms that should take place, but that are not politically feasible. It was hoped at the time of the euro's creation that such reforms would happen along the way, but the problem now is that Eurozone politics is increasingly charged and show few signs of commonality. The euro project has been arrested in its adolescence; its politics and institutional structure have not matured with

increase age. The euro system needs to grow older and wiser, but the prime argument of this paper is that it first needs to be saved from premature death.

TIME TO PUT THE MOUTH WHERE THE MONEY IS

Eurozone countries suffer from many different crises. They have one thing in common – the quest for ultimate responsibility: at which point is responsibility no longer passed on to others? Or as Harry Truman would have phrased it: where does the buck stops? What markets need to know is: if the euro system is getting close to its breaking point, will anyone step in to stop it from breaking apart? Arguably, there is only one actor in Europe with pockets deep enough to offer such a systemic guarantee for the Eurozone. And it is not Germany. In fact, it is delusory to think that Germany, or any other government, has the capacity to give the systemic guarantee of the euro's survival that is now absent. No, that actor is the European Central Bank.

The Eurozone's strategy has been to offer external assistance – through the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), the latter still not operational – to countries that would default without that support. The International Monetary Fund (IMF) has also sponsored the programmes agreed for Greece, Ireland, and Portugal, but the multilateral body has taken a junior financial role in these bailouts. The overall strategy has been successful in so far as it has achieved the initial ambition of avoiding defaults as far as it has been possible. But it is difficult to find many other positive things to say about the efficacy of these programmes. And it is partly a consequence of the initial ambition – avoiding defaults – being misguided.

Two of the countries that have received assistance – Greece and Ireland – should have gone through default proceedings straight away. In fact, Greek debt was unsustainable already in May 2010 (and, of course, before that) when Greece received its first package. The absence of a debt restructuring in the first orchestrated crisis response is partly responsible for Greece being thrown into a depression spiral. Adding new debt through a bailout only made the debt problems worse. And the new debt that was added, which came from public entities, will be much harder (and politically controversial) to restructure. The Eurozone's policy towards Greece also added a dimension of ridicule to how the outside world viewed the Eurozone's capacity for crisis leadership. No one with insight into the Greek economy thought the country would be relieved from its pains because of the programme. The more that Eurozone leaders tried to promote the virtues of the bailout, the more financial markets started to doubt the financial acumen of the Eurozone's political masters.

Ireland was in a different position than Greece. The sources of the two crises were different, even if the both shared the experience of government expenditures expanding unsustainably fast in the years leading up to the crisis. Ireland had a classic boom-and-bust cycle – yet more vicious than many other examples of such crises – and what pushed the country to the brink of default was its epic housing bust that wrecked some of the Irish banks. The previous Irish government recklessly decided to put the liabilities of these banks on its own books, forcing the government to accept, somewhat reluctantly, a bailout in late 2010. In effect, Irish taxpayers had to pay for the excesses in Irish banks during the asset boom. However, these banks – today merged into the Irish Bank Resolution Corporation – are dead entities. They should have been put in default already in 2008 when the Irish government started to inject money into the Anglo Irish Bank.

Flawed Eurozone arithmetic

A BIGGER PROBLEM for the Eurozone is that it never convinced markets that it would be prepared to expand the size of the bailout mechanisms to deal with an escalating crisis that would push one or several big economies to the brink of default. The EFSF was from its start a mechanism to channel support to smaller economies. The total size of the EFSF was limited, and the construction of the facility was based on the assumption that the bigger economies would not request assistance from it. If they would, their own contributions to the EFSF would be withdrawn from the structure of financial guarantees that is the basis for the EFSF when it raises capital to the countries in need of assistance. If that would happen, the structure would unravel.

The next move from Eurozone leaders, decided at the crisis summit in late October 2011, was to leverage these paltry guarantees. Through an arcane process of collateralization, the EFSF's 440 billion euro capacity would be leveraged up to at least one trillion euro. But that strategy failed miserably – and it became yet another embarrassing episode in the crisis. Eurozone leaders could not convince potential investors to invest, like Chinese authorities and state-owned firms, who naturally were asking for assurances that this would be a safe investment.

The ESM was developed in parallel with discussions to expand and leverage the EFSF. Initially pitched as a mechanism to comprehensively address debt unsustainability, with a clear signal that the Eurozone would not blink if it would be needed to restructure debt, the ESM was progressively changed through a series of political compromises. Oddly, the decision to restructure Greek debt was almost regretted by Eurozone leaders. The message communicated from the crisis summit in December was that the process of a Greek debt restructuring had thrown other Eurozone economies into turmoil, as investors allegedly feared their investments would be written down. Consequently, Eurozone leaders reversed at least the rhetoric on future debt restructurings. The ESM could still initiate debt-sustainability reviews, possibly leading to debt restructurings in the event that debt was considered unsustainable, but the new agreement was promoted as a rejection of debt write downs.

Three other changes of the ESM have been, or are likely to be, made. It will now be up and running in a few months (or so it seems), not exactly but roughly a year ahead of the previously planned starting date. The ESM will not to be given senior creditor status (although that issue is still a complication in the design of a bailout package to Spain). And, finally, the capacity – or firepower – of the bailout mechanism was expanded at a summit in early 2012.

However, one of the key problems with the ESM remains: it is grossly inadequate to deal with a scenario when one or several bigger economies will need external financial assistance to avoid defaults. As developments in the past months have shown, such a scenario is not a distant reality.

To have calming effects on markets, the firepower of any bailout mechanism would have to be in excess of 2 trillion euros. Together, the EFSF and the ESM have the capacity to lend another 500 billion euro to countries. As the Eurozone has committed itself to assist the Spanish banking sector with 100 billion euro, only 400 billion euro remains. And it is highly likely that Ireland and Portugal will need new assistance beyond their current programmes. Assuming an overall supportive economic environment, they will not need as much as they received in their first packages. But it is not to stretch the imagination too far to suggest another 100 billion euro in the Eurozone's bailout capacity will have to be committed to Portugal and Ireland. And even in these programmes do not expire soon, decisions about further assistance will have to be taken in the next few months.

Furthermore, Cyprus has requested support and will need assistance in the 5-10 billion euro region. And, finally, Greece will need further assistance, especially if the resistance to another restructuring of Greek debt remains. But even if Greece's debt is restructured, resources from the EFSF or the ESM will have to be committed to Greece – and

possibly to other official actors (creditors) who will be affected by the debt write down. The new bailout package to Greece is yet only a few months old, but it is likely that this package will have to be revisited before the end of this year. To sum this up, it is likely that at least 250 of the existing 500 billion euros will have to cover existing or additional commitments to assisted countries.

Yet 250 billion euros will not take the Eurozone far if Spain will need assistance to avoid a sovereign default – that is, assistance in addition to the resources already committed to Spain's fragile banking sector. If yields on Spanish 10-year bonds remain in excess of 7 percent (yields on shorter-term government paper are also spiking) it is a matter of months until Spain will have to seek external assistance to avoid a default.

Italy is in a similar situation. Its bond yields are in the danger zone and continue to climb. Italy's stock of debt is much higher than Spain's – Italy's public debt is close to 2 trillion euro – and even if its fiscal deficit is far smaller than Spain's, it has to roll over significant amounts of debt at these high yields. As shown in Table 1, together they will have to borrow a little more than 600 billion euro from now up to the end of 2014. In fact, they need to borrow more than 600 billion euro – in total 960 billion euro for 2012-2014 – if all redemptions (including short-term debt) are accounted.[5] But where would that money come from?

Sufficient amounts of money to cover such a scenario simply are not available in the Eurozone's bailout structure. If all new resources recently raised by the IMF are also used – which is to stretch the amount a country can draw from the IMF relative to its quota – the total financing needs for Spain and Italy in 2012-2014 could possibly be covered. But that would exhaust all existing committed resources, and a structure like the ESM is not built to be completely exhausted. Its credibility on the markets is based on the combination of paid-in capital (only 80 billion euro of the 500 billion euro in lending capacity) and the capacity of big solvent economies to actually cover their capital-subscription liabilities if that is needed. But under the assumption that two of its biggest contributors – Italy and Spain – are clients of the ESM, and that France's credibility till be tarnished as a consequence, it is difficult to see how that credibility could remain. Like other schemes of this kind, it is durable only so long as investors believe that countries will not be asked to cover their liabilities.

The structure of the ESM is also one of the reasons for why there is opposition to allowing it to invest directly in banks. What if the banks that receive ESM capital go bust? That would immediately trigger a balance problem within the ESM, and given the fragile nature of banks in Europe it is understandable that some countries demand that a sovereign should stand between the banks and the ESM.

As the European economy has continued to sour since the IMF's fiscal forecast in April, which is the basis for Table 1, and that bailouts of Spain and Italy possibly would have to stretch beyond 2014 (and have contracting effects on economic activity in Europe), it is likely that existing resources would continue to grow paler in comparison with the increasing financing needs.

TABLE 1: SPAIN AND ITALY – GOVERNMENT FINANCING NEEDS

	20012H2*	2013*	2014*	Total (bn euro)
SPAIN				
Budget deficit	6.0	5.7	5.2	62
Maturing debt	14.8	15.8	14.7	171
Total	20.8	21.5	20.0	232
ITALY				
Budget deficit	2.4	1.5	1.6	24
Maturing debt	26.4	22.4	22.6	356
Total	28.8	23.9	24.2	380
Grand total	-	-	-	612

*Percent of GDP
Source: IMF (2012) and Gavyn Davies[6]

"Neither a borrower nor a lender be": can debt be mutualised?

It is unlikely that the Eurozone's bailout structure will increase its firepower to a considerable degree. Even if the countries that have resisted a vast expansion of country commitments to the EFSF or the ESM would change their minds, there is an economic limit to have much they can add. And given that public debt levels in countries like Germany and France are already in excess of 80 percent of GDP, and climbing, the big Eurozone sovereigns cannot take on liabilities of that kind without substantially damaging their own economies.

This is certainly true of France, which is teetering worryingly close to the GIPS group of countries. But it is also true of Germany. So far Germany has enjoyed super-low yields on its bonds, but it is a pipe dream that German bunds could remain in that region if the problems in Europe grow bigger. And assuming that the credibility of the ESM will be shaken, Germany – with a capital subscription of almost 200 billion euro in that mechanism – will be severely affected.

Equally important, there are political limits to how much money that governments and electorates are prepared to commit to bailouts. It is probably possible for the more solvent governments to make additional commitments to the ESM, but it is unrealistic to believe that its firepower could increase considerably. Such cross-border solidarity simply does not exist.

The other big idea on the table is for the Eurozone to mutualise debt through some form of Eurobond. Whatever the economic merits of this idea – and there certainly are solid economic arguments in favour of Eurobonds – it is probably safe to say that Eurobonds will not be the solution to the current crisis. The political will for Eurobonds is not big enough – and, undoubtedly, the economic rational for them are weaker under current economic weather conditions. For all countries to agree to Eurobonds, current debt problems will first have to resolved. This may sound as an inverted logic, but the crude political economy of it is that countries that are now in the position to lend credibility, or extend their solvency, to less solvent (or insolvent) countries will not accept liability of debt in those countries unless they can get the power to manage those countries' fiscal affairs.[7] But there is a political constraint in the other direction, too. No country seems prepared to accept such a loss of sovereignty.

Yet the resistance to Eurobonds is politically understandable also in a post-crisis perspective. It is a permanent system that would be infected by moral hazard problems unless a system for effective *and* legitimate control of fiscal policy can be designed. And that system has yet to step forward. One could easily imagine systems of forceful control of fiscal balances. Some of them were floated in the debate over the fiscal compact.

But they were also rejected – partly because they did not stand the test of legitimacy. Worryingly, that is also true of other,

and milder, mechanisms for fiscal control that would accompany Eurobonds. To put it in a contemporary political context: critical parts of the political programme of President Hollande, the new French leader, some of which is now being implemented, would hardly pass the fiscal policy tests that the Eurozone's hardliners would demand. Imagine the outcry in France if Germany or the European Commission would prohibit the French government to undertake thee policies.

There are two critical aspects of legitimacy. First, the pooling of fiscal sovereignty must resonate with constitutions and electorates. In other words, new systems for fiscal policy must be democratically acceptable. The challenge, of course, is that an effective system needs to have the power to intervene in areas of sizeable government expenditures that may pose problems in the future. A fiscal surplus can turn into a huge fiscal deficit in a few years time if expenditure pressures are not managed. Inevitably, an effective system to avoid moral hazard must enable other countries, or European institutions, to demand governments to cut expenditures, or pursue other reforms, in areas like healthcare and pension systems. If, say, a new French President would like to lower the pensions age for some, that would effectively not be possible without the consent of other countries. Furthermore, the sovereignty of regional or local authorities will have to be curtailed as they represent a significant part of spending in several Eurozone countries. Consequently, several governments will need to go through a process of constitutional change to enable effective systems for fiscal control at the Eurozone level.

Second, the design of a system for fiscal responsibility must be flexible to natural business cycle fluctuations in fiscal policy. Heavy-handed rules, with little or no flexibility for a majority to exempt countries from these rules, would not really stand that test, especially as there is no universal pattern in the Eurozone how economies and fiscal policies react to swings in the business cycle. The risk is that the Eurozone ends up with the same problem as in its monetary policy: a narrow target (inflation targeting, in the case of the ECB), with disproportionate representation of Germany in analyses and conduct of policy, will erode the process of natural recovery and moderation in business cycles.

If Eurozone leaders would gloss over these problems and impose a top-down structure for fiscal-policy control, it would surely cause huge frictions in the way that the Eurozone, and the European Union, works. Those frictions are already at display – and the cat-and-mouse game in the past two years between Eurozone institutions and governments reluctant to reform has hardly been a showcase for a system of shared liability. In this Shakespeare was correct when, in Hamlet, he let Polonius counsel his son:

Neither a borrower nor a lender be,
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.

No taxation without representation, was the credo for the eighteenth century independence movement in the United States. And a system of Eurobonds, which in effect would be a tax on solvent countries as long as debt problems remain (perhaps even after debt problems have been resolved), would not work without a different system of political representation in Europe. Yet it is a bold, let alone distant, notion that countries in the Eurozone would take that leap of faith at a time when euro scepticism is growing.

Germany has suggested that Eurozone countries, plus other willing followers, should create a political union, a precursor to fiscal integration and mutualisation of debt. The argument is understandable, but it is disingenuous. Germany, and especially the two governing parties, does not really believe in that process, especially if a political union would be a force for much stronger pooling of fiscal sovereignty in the Eurozone. And the electorate seems unlikely to swallow it. True, opinions may change, but the German opinion has never been particularly fond of the euro. If the shift from the Deutschmark to the euro had been put to the electorate in a referendum, the result would by all probability have been

negative. And it is difficult to imagine any other course of action than that a political union, or a stand-alone proposal to mutualise debt, would have to be put to the people in a referendum.

Frankfurt, we have a problem!

So what is then the solution?

Given the growing scale of the debt problems in the Eurozone, and the alarmingly acute situation for some Eurozone countries, there is arguably no other viable alternative than having the ECB to step in by giving a systemic guarantee of the euro system. It could do so by its own actions, or by allowing an ESM with a banking license access to central bank refinancing as any other credit institution. The alternative is a break-up of the Eurozone, followed by severe sovereign and banking defaults. The cost of that alternative is prohibitive; it simply cannot be allowed to happen.

The immediate response by some people, notably the Bundesbank, is that central-bank funding of sovereigns would violate the European treaty. However, that line of argument is not exactly correct. Whether central bank support of governments is allowed under the treaty is a complicated question, and those who designed the system were obviously not in consensus. Consequently, the treaty, in the first paragraph in Article 123, does not prohibit central bank funding of governments as long as it is done in an indirect way.

The ECB has already demonstrated that it can intervene on sovereign bond markets – indeed, even to play the role of a temporary lender of last resort to sovereigns, and a market maker of last resort, intervening on debt markets and with debt instruments with the consequence of supporting sovereigns. Those who believe, as some observers still seem to do, that the ECB only acts, and only can act, on money markets are wrong. Under the Securities Market Programme (SMP), the ECB has intervened on secondary bond markets. Outstanding sovereign debt from the peripheral countries under the SMP still exceeds 200 billion euro, even if there is not much new purchasing in that programme.

Sovereign bond markets have also been assisted indirectly through the ECB's Covered Bonds Purchase Programme, which was activated in 2009 and now only holds bonds (approximately 60 billion euro) to maturity. Furthermore, the Long Term Refinancing Operation (LTRO) had visible effects on banks' purchasing of bonds in troubled peripheral countries. One need not have a predilection for conspiracy theories to argue that this was not an unintended consequence of the LTRO. Lastly, national central banks in the ESCB system have pledged capital (approximately 50 billion euro) to the IMF's new fundraising drive to effectively enable assistance to Eurozone countries. In other words, the ECB has already proven that it can act on sovereign bond markets.

Another argument against an ECB-based intervention to offer the systemic guarantee for the euro's survival is that it would not be desirable. This is a different type of argument, and one that it is easy to have sympathy for. Governments or currency unions should never be so mismanaged that they require life-saving surgery from central banks. Arguably, constitutions and rules should be designed to that end. But what should happen in the event that the scale of mismanagement is threatening a currency with extinction? What if the desired policy is no longer an option on the menu?

The relevant question now (or in the next few months – the time that Eurozone governments have to decide whether they want to continue in a currency union) is whether the undesirable is preferable to any other likely course of events. It should not be difficult to make that choice. The instinct for survival should trump the faiblesse for central bank purity. Arguably, as long as countries will run central-bank based financial systems there is a constitutional need to have a lender of last resort to sovereigns when other measures are, for a variety of reasons, impossible or exhausted. The Eurozone is very soon at that point. It needs to show where responsibility is no longer passed on to others.

Four arguments are critical in this context. First, the interpretation of the Treaty's view on how monetary policy should be conducted is often too biased in favour of a post-war German approach to central banking. The treaty itself does not give as detailed prescriptions as many observers assume, but from its start the development of the ECB leaned in the Bundesbank direction.[8] One can debate if this has been a successful strategy for the Eurozone as a whole. I believe it has been moderately successful. However, there have been too much focus on a narrow inflation target, and too little focus on monetary disequilibrium, e.g. the role that monetary policy played in the build-up of the asset boom in some Eurozone countries.

Regardless of that view, a strong case can be made in favour of an ECB that generally acts on debt markets and with debt instruments in crisis situations. On the occasions it has used them to support solvent entities, in contrast to purchasing bonds issued by an obviously insolvent country, the results have been positive.[9] And this case is not built on Keynesian faith or "funny money" ideology, but on solid monetarist grounds.[10] The ECB's resistance to quantitative easing, for instance, has fitted the German economy, which has not experienced a severe drop in money supply. But other Eurozone countries would have gained from ECB actions that would increase private money supply (not base or high-powered money). The absence of such actions, combined with various policies to forcefully and rapidly recapitalise banks, have had a disastrous effect on money supply. It is not an exaggeration to say that some Eurozone countries are going through a similar phase of monetary contraction as the United States in the early 1930s. The current passive monetary contraction will have to be stopped if the recovery in the Eurozone is to speed up.

Second, an ECB that gives a systemic guarantee, and acts accordingly, will not have to be a replay of the Weimar years when a central bank caused runaway inflation by the money-printing machine. The ECB's non-inflationary loss-absorption capacity, over a few years, is in excess of 3 trillion euro.[11] The ECB is today far away from the point when its own assets and income no longer could accommodate an expansion of its balance sheet. But the main point is that the ECB would never have to go that far in order to play the role of a lender of last resort to sovereigns. Yields in distressed markets would likely moderate markedly if it became clear that the ECB was acting in such a way.

Third, the ECB is and should remain an independent central bank. But central bank independence is constitutional; it does not mean that central banks should make decisions independently of macro-economic conditions, as too much focus on narrow rules sometimes imply. The ECB cannot be forced to act as lender of last resort to sovereigns. It is a decision it has to make for itself. While this principle applies to actions by the ECB on the bond markets, the central bank has less independence when a public credit institution asks for access to central bank refinancing. It has to be given the same treatment as a private credit institution. And the ECB has shown a remarkable flexibility in providing access to banks in emergency situations.

Fourth, even if the ECB could do the heavy lifting alone, it needs the support of governments that act to contain moral hazard problems. This is arguably one of the chief reasons to why the ECB only cautiously has intervened on bond markets for countries that are considered solvent but suffer form liquidity problems. The ECB fears such support would ease the pressure on governments to reform fiscal and economy policy. This fear surfaced last autumn when the ECB outlined its view about necessary economic reforms in Italy in a letter to the former Italian Prime Minister, Silvio Berlusconi, at a time when support to drive down bond yields was discussed. It is also at the centre of the criticism against unorthodox ECB actions levelled by Jürgen Stark and other German central bank dignitaries.

There really is no optimal way for the ECB to avoid moral hazard. Italy is a bigger problem than Spain. Spain has an elected government that has been determined to push through needed reforms. That programme needs to continue, and the pace of fiscal adjustment will probably slow down, but there is not a fundamental conflict about the direction of Spanish economic policy. Italy, however, has a technocrat government with declining support from the senate. Next year it will go to parliamentary elections, and it is highly likely that the economic and fiscal reform programme will

become the whipping boy of Italy's many political populists. There is not much that other Eurozone governments can do to avoid such a course of events. What they can do, however, is to tie Italy as much as possible to a reform programme, in exchange for easing its debt conditions, before the election. The ECB could also choose to only support Spanish bonds, putting stronger pressure on Italy's political elite to support Prime Minister Monti's reforms. Finding the right oral defence for such a policy – and, more generally, for greater activism – is critical, both to signal that it complies with the Treaty and it is prepared to assume a greater role on the bond markets.

Both Spain and Italy will likely need external assistance to support their fiscal adjustments. Yet they do not need full bailout packages of the kind that Greece, Ireland and Portugal have received – and, frankly, there are not resources available to cover full bailout packages for both of them. But they would do better if they had crutches to underpin their fiscal adjustments and, in the case of Italy, to get the political system to focus on necessary economic reforms. One way to build such crutches is to combine financial support by the ESM and the IMF. Such support should not be full packages to cover the entire refinancing need for Spain and Italy in the forthcoming years. It could rather be an extended credit line for countries to utilise when liquidity problems get too big. Nor should the support be done though bond purchasing by the ESM. It has to be based on an agreed programme with the governments. Those agreements should also specify necessary reform conditions – preferably focused at further structural economic reforms rather than short-term fiscal adjustment.

PACE, NOT SPACE, IN FISCAL POLICY ADJUSTMENT

Fiscal adjustment programmes need to be flexible to the overall economic conditions and the business cycles in member states' economies. In the medium-to-long term many Eurozone countries need to cut expenditures, and quite radically so, but in the short-to-medium term fiscal policy should be kept "neutral" and not be pro-cyclical. Crisis economies have no fiscal space for Keynesian stimulus programmes: that debate is a dead-end street. But the pace of short-term fiscal adjustment should slow down in some countries. The measure of fiscal discipline that should be used by Eurozone institutions is not the fiscal balance next year but in 3-5 years time.

The latest instalment in the erratic debate over the Eurozone's crisis policy is one generally portrayed as *growth versus austerity*. Oddly, or perhaps ironically, it is a debate inspired by a European politician, President Hollande, who seems on track to introduce remarkably growth-unfriendly policy. Yet Hollande's view is a sideshow – and more thoughtful observers espouse the case against austerity. They argue, with increasing passion, that the Eurozone now is repeating the mistakes of fiscal policy during the Great Depression. With a few exceptions, people on that side of the argument leans toward Keynesian economics, and they believe that classic or Austrian economics is yet again pushing countries right into depression. It is an appealing view. Few developments in modern economics have been so interesting as the dispute between Keynes and the Austrians. Yet it is a disingenuous argument.

First, no one in government position in Europe (or elsewhere), and hardly anyone outside government, is repeating the argument of Friedrich Hayek or the Austrians in the late 1920s and early 1930s. Their view was basically that monetary policy as well as fiscal policy should be contractionary rather than expansionary. Expansionary policies were artificial stimulants and the right policy, in Hayek's view, was to "leave it to time to effect a permanent cure". Consequently, Hayek's initial response to the Great Depression was for central banks to raise the interest rates in order to increase savings and investments. No one is making this argument today – and Hayek would not, if he had been alive (he changed his mind at a later stage). One can be critical of modern austerity kings and queens in Europe, but it is dishonest to put them in the corner of past depressionistas.

Second, both austerity preachers and those of Keynesian faith make the mistake of propagating one general cure for countries that are in very different economic positions and suffering from different illnesses. The debate is very Mani-

chean and balanced opinions, it seems, have been one of the casualties of Europe's crisis. In effect, people on the left, typically Keynesians, argue in favour of fiscal expansion rather than austerity, and people on the right seems to believe that all countries can manage to go through a Baltic economic cure this late in the crisis cycle.

Reality, however, fits neither the Keynesians nor the austerians. Let us take the four countries at the epicentre of the Eurozone crisis – Greece, Ireland, Portugal and Spain. They have three things in common. First, total debt in these countries expanded rapidly throughout the past decade – either because of increased government borrowing (Greece and Portugal) or through a rapid build-up of private debt (Ireland and Spain).

Second, they all run substantial current account deficits in the years up to the crisis. And, lastly, government spending grew by remarkably high rates in that period. State spending in Greece and Spain increased by 50-55 percent in the five years before the crisis started. In Portugal it 'only' grew by 35 percent. Ireland, on the other hand, expanded government spending by almost 75 percent. No other country in Western Europe was close to these growth rates.

The first two problems are understood (but not really accommodated) in the Keynesian arsenal, but not by the austerians. The third problem, however, contradicts the Keynesian gospel. It goes without saying that the welfare state expansion in Greece and Portugal is part of the story why they ended up as clients of Europe's bailout mechanisms. After all, Greece expanded its debt by an annual average of 5.7% between 2001 and 2007 (the figure for Portugal is 3.8%). But Ireland and Spain, too, had problems with rapid expansion of the state. A big part of rising affluence during the fat years was generated by the escalating real estate bubble. That bubble drove up real estate prices and private debt. It boosted the construction sector and, more generally, pushed domestic consumption to the point where the country had to borrow 7-8% of the GDP every year to finance its expenditures. Like other bubbles, it spearheaded rapid economic growth, which allowed governments to expand the state equally rapidly.

But that growth vanished. Gold turned unto sand. Simply, the boom had not been sustainable. What had been a record of solid fiscal surpluses was quickly turned into high structural fiscal deficits. Spain, for instance, entered 2008 with the second strongest budget surplus (slightly above 2%) in the entire Eurozone. It ended 2009 with the second worst structural deficit (above 9%).

This is a familiar story of the crisis. Yet surprisingly few in Europe have bothered to understand the role played by the welfare state and government expenditures in the crisis. The European debate has zoomed in on two extreme positions, both bordering to the caricature. It's Keynesians versus 'Germans', or fiscalists versus cameralists. The first school has a penchant for cradle-to-grave welfare states and sees the main fault line in grossly insufficient fiscal expansion during the crisis. The other school blames the entire Eurozone crisis on budget deficits and lack of fiscal discipline. One thinks thrift is a vice, the other sees deficits as immoral. They also have their fixes at the ready: a government spending spree or an austerity purification rite.

The conclusion, then, is that Spain goes through both a boom-and-bust crisis and a government-spending crisis. Both need to be fixed. The Eurozone's policy towards Spain has been one demanding rapid fiscal adjustment, aiming to close the deficit in a few years time. Yet this is almost impossible in a country like Spain. But the alternative is not to avoid all sorts of expenditure reforms, or to reject demands in that direction. In fact, it is critical that spending reforms, aiming at cutting the structural deficit in the medium term, are undertaken immediately. But medium-term is the key words. Durable spending reforms require time. The desired fiscal effects will be generated in 3-5 years. In contrast, slash-and-burn expenditure cuts tend to cut expenditures in the short term but have little effect in the medium term. And when they are combined with rash tax hikes, austerity programmes run the clear risk of being pro-cyclical. Furthermore, structural economic reforms that could support growth and fiscal adjustment in the medium term

Other countries are in different positions. Italy does not suffer from a boom-and-bust crisis. It runs a primary fiscal surplus but its credibility is weighed down by huge public debts and chronically low economic growth. Greece is stuck in a depression cycle and needs another round of substantial debt write downs, this time taking the public debt ratio south of 50 percent of GDP. Portugal needs more time for its economy to deleverage, and need to reform its economy and state institutions considerably. Ireland should be allowed to let go of its rotten banks. Germany, like the Nordic countries, is in a position to undertake economic reforms that in the short term will increase its fiscal deficit. The list could continue, but the simple point is this: the only common narrative for all countries in the Eurozone is that they need to increase their growth potentials through structural economic reforms. Their macro-economic policies, however, should differ substantially because they are fighting different problems and are in different positions in the recovery cycle. Importantly, countries that are going through a boom-and-bust correction need more time to close their fiscal deficits than what heavy-handed Eurozone rules allow.

THE WAY FORWARD FOR EUROZONE COOPERATION

The Eurozone crisis has laid bare the deficient institutional structure for economic policy in Europe. It has also eroded the narrative of European cooperation – a step-by-step, integrative project to foster growth and convergence. Some of the political architects of the Economic and Monetary Union (EMU) knew that the institutional structure was deficient, but made the bold bet that it would be fixed as soon as it run into a crisis. It was an incredibly naïve bet – and one that they, hopefully, live to regret. But it also shows past leaders' faith in perennial European integration. Political leaders today, however, look at European cooperation in somewhat different ways. They have less faith in its inevitability and do not think of the process as unstoppable. Importantly, they are facing electorates that are increasingly unwilling to support further European integration, especially when it involves transferring more resources to the EU. So the institutional evolution of the Eurozone, and of the EU in general, is stuck. The plan for a European constitution – the "Madison moment" – was wrecked by people in France and the Netherlands, who rejected it in referendums. Now into its adolescence, the institutional development of the EMU has been arrested.

The question is: where does the Eurozone go from here? Some favour the Eurozone, perhaps the EU at large, to take a big leap forward to a "political union", a nebulous notion but one that allegedly would enable fiscal integration (pooling fiscal sovereignty) and sharing liabilities for debt. It is an interesting idea, but the odds remain heavily stacked against it. Germany has allegedly thrown its weight behind a political union, but that support should be seen in a particular context: it is an expedient way of saying Nein to Eurobonds or a full banking union in the short or medium term.

Germany, and many other countries, is not going to seriously entertain the notion of shared liability of debt until there is no longer a risk that German taxpayers would have to foot the bill for deficit sinners. The same logic guides the resistance to a full banking union: with over two trillion in deposits in countries with unstable banks, and no set-aside funds to cover expenses for their deposit insurance schemes, you may end up with Schwarze Peter on your hand if you agree to a full banking union (including a joint structure for deposit insurance and joint financing of costly bank resolutions) before the systemic fragilities in the Europe's banking sector have been addressed.

The mechanisms of fiscal-policy surveillance have been enforced. It is only natural if also cooperation on financial surveillance increased, with the view of establishing a banking union in due course. Yet none of these measures would be sufficient – or arouse stronger popular sentiments for European integration. In fact, it is difficult to see what further steps in the EMU that could recover the narrative of post-war European cooperation and the forces of convergence in the European economy. And this is the key structural problem for the Eurozone. It has to move forward to survive in the long term, but it is now arrested in its adolescence.

The narrative could be found elsewhere. To be a Marxian about it, the material base for that political super-structure is the single market, or in what is called the four freedoms of Europe. These four freedoms are still aspirational, honoured in the breach rather than observance, but they are convincing and connect aspirations with reality. And the growth potential in further single-market reforms remains considerable. A programme built on completing the single market also has the benefit of putting demands on all countries, and not just the Mediterranean countries that are in economic difficulties. For example, some of the biggest sinners in market openness for services are in Europe's Northern regions (including Germany).

Yet such a narrative for the EMU will not be in demand if the Eurozone cannot change its current course towards extinction. The buck stops in Frankfurt. It is now time to act on that understanding.

ENDNOTES

1. The quote has been taken from Edward Luce's *Time to Start Thinking: America and the Spectre of Decline.* Little Brown, 2012
2. Fredrik Erixon (2012), *European Vertigo: Remedying the Eurozone Crisis*. Memo to the EU summit, December 7, 2011, accessed at http://www.ecipe.org/media/external_publication_pdfs/european-vertigo.pdf
3. Alexander Hamilton was co-author of the Federalist Papers (James Madison and John Jay were the other two authors), the first U.S. Treasury Secretary, and originator of the U.S. Federal Reserve and the federalisation of U.S. state debts. James Madison was involved in drafting and championing the U.S. Constitution and the U.S. Bill of Rights.
4. Marsh, David (2009), *The Euro: The Politics of the New Global Currency*. New Haven: Yale University Press
5. The 600 billion figure is drawn from International Monetary Fund (2012), *Fiscal Monitor: Balancing Fiscal Policy Risks*. Washington, DC: IMF. It does not include short-term debt. The 980 billion figure comes from Buiter, Willem & Rahbari, Ebrahim (2012), *Global Economics View*, February 2012. Citi Investment Research and Analysis. An estimate by the Buiter and Rahbari suggest that all redemptions (all maturing debt) in the "soft" Eurozone countries (Greece, Ireland, Portugal, Belgium, Spain, Italy and France) in 2012-2014 add up to a little more than 1.9 trillion euro.
6. The table is retrieved from Gavyn Davies excellent blog, http://blogs.ft.com/gavyndavies/2012/06/22/some-unpleasant-eurozone-arithmetic/#axzz1yWfmp4Au
7. This is not to say that solvent countries with high fiscal credibility would not gain from Eurobonds. In fact, many of the smaller countries in that group would benefit from access to more liquid bond markets. But that argument is not really valid in the short term, given current conditions in Eurozone bond markets.
8. Issing, Otmar (2008), *The Birth of the Euro*. Cambridge: Cambridge University Press
9. See, for instance, European Central Bank (2011), *The Impact of the Eurosystem's Covered Bond Purchase Programme on the Primary and Secondary Markets*. Occasional Paper No. 122. Frankfurt: ECB
10. Tim Congdon (2011), *Money in a Free Society: Keynes, Friedman and the New Crisis in Capitalism*. Encounter Books
11. Buiter & Rahbari, Ibid

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