

European Debt Crisis: What Is The Way Out

By Charles Wyplosz*

The current European debt crisis is just bringing to the fore well-defined cracks in the Eurozone's construction. These cracks were hidden by policymakers. Moreover, fiscal discipline was left in the careless hands of national governments, banking regulation and supervision was delegated to national authorities more interested in promoting national champions than in completing the Single Market and crisis management was masterminded not by the Commission but by national governments with poor analytical support. It was believed that, at least, the staunchly independent European Central Bank (ECB) would remain a beacon of careful and precise thinking, only to discover that monetary policy dominance – the ability of a central bank to reject responsibility for enforcing the budget constraint – is extraordinarily fragile.

As always the situation is made worse because economists disagree on everything, from diagnosis to policy recommendations. This leaves panicked policymakers with the firm view that economics is largely useless and that any policy can be pursued if it makes good political sense. Below are clouded, but vital economic and political issues in need of discussion.

Enforcing Fiscal Discipline in the Eurozone

The Treaty gives two mutually incompatible answers: member states are sovereign in fiscal matters; while the Stability and Growth Pact imposes limits on national fiscal policies. From the experience of federal states, sub-federal units cannot enjoy full sovereignty. This is the reason behind the Pact and the intuition behind calls for a toughening of its operation. The creation of the €440 billion European Financial Stability Fund, and the moral hazard implied by its rescue, is a federalist step that pushes the Eurozone in this direction. Yet, no matter how tough the pact, at the end of the day it clashes with national sovereignty. Either Eurozone members will have the collective will to roll back national sovereignty, or current plans will founder.

Those who defend the tough Pact option note that, already, Greece and Ireland have experienced such a roll-back. They are right, but the conditions imposed upon Greece and Ireland are part of a standard IMF program, even if the programs have been jointly mooted with the Commission. In addition, it is one thing to impose on national sovereignty in the midst of a crisis; it is something else to do so routinely as part of on-going surveillance.

Even though most people think that it is reasonable to paper over the Treaty's cracks, the crisis has shown that it is very costly, and possibly lethal. There are two responses: explicitly limit sovereignty whenever fiscal discipline is in jeopardy or recognize that fiscal discipline can only be achieved at the national level. The first option clearly requires a new treaty, but defining precisely how this is to be done will prove to be tricky and ratification by all member states is far from guaranteed. The second approach requires that each Eurozone member country adopt formal procedures or rules that are known to deliver fiscal discipline, specifically a German-style balanced-budget rule. Whether this can be achieved voluntarily without a new treaty is an open question.

How Should A Sovereign Debt Restructuring Be Handled?

The crisis has also brought home the fact that sovereign debt defaults cannot be ruled out. When the discipline problem is solved the issue will be moot, but this is bound to take some time. We have to go through 2011 better equipped than in 2010. Again, the question remains: Should any debt restructuring be left to the discretion of each individual country? Alternatively, should there be collective constraint because it is "a matter of common concern"? Here too, there is a contradiction between collective interests and national sovereignty.

There are two valid arguments for making debt restructuring a collective issue: an externality and conditionality. The externality arises if one country's restructuring raises alarm in the markets and adversely affects other Eurozone member countries. This argument must be made more precise, however. What exactly would be the channel(s) of contagion? No one believes that a debt restructuring in California would trigger contagion within the U.S. dollar area, so this is not a common currency effect. Several assumptions can be entertained, all of which rest on multiple equilibria. It could be that markets expect some collective support from other countries, leading them to seek clarification.

In this case, the first best response is to offer such clarification *ex ante*. It could be that markets fear that some Eurozone banks would suffer large losses, even be socialized and thus weaken corresponding governments. Here the first best response is to strengthen the exposed banks through adequate recapitalization and, failing that, to design bank resolution processes that would protect the depositors with limited costs to taxpayers. Alternatively, markets could panic as they realize that Eurozone sovereign debts are riskier than hitherto believed. At any rate, the first best solution is for all countries to come up with credible debt stabilization plans, precisely the alternative envisioned in the previous section.

The other argument, conditionality, is the basis of current "bail-in" discussions: if and when a country needs to be supported by Eurozone taxpayers, it would make sense that creditors also be asked to chip in. In the future, any bail-out operation financed by the successor to the European Financial Stability Fund would involve an obligation to restructure the debt. This is a powerful argument, so powerful in fact that it is surprising that it is not being applied to current and forthcoming bail-outs. It could be legal considerations, the lack of instruments, the need to protect weak banks, or a fear of contagion in the absence of a worked-out plan.

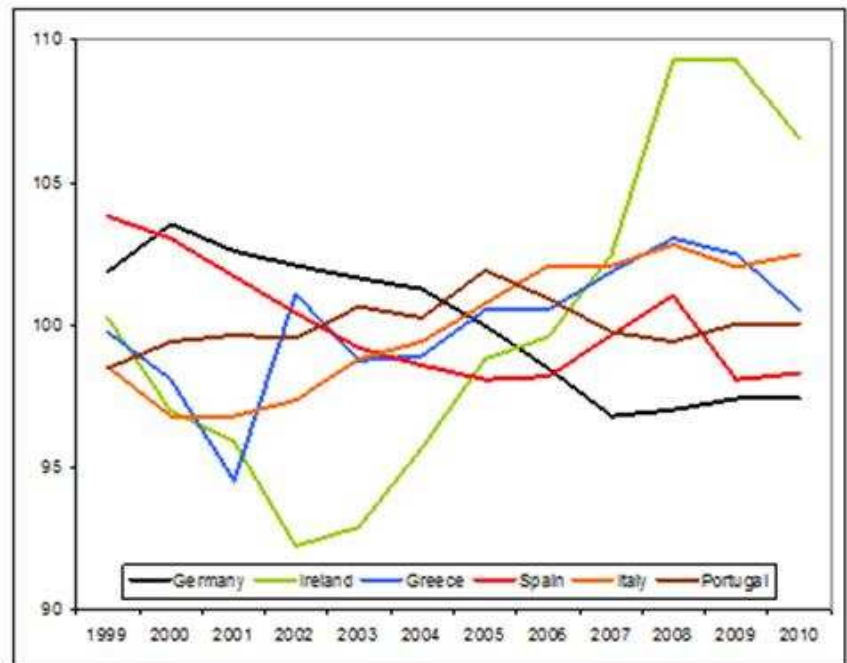
This is all fine, but is it necessary to expand considerable intellectual efforts and political capital to organize debt restructurings? Surely it would be much better to establish fiscal discipline and dispense with painful situations. In a way, these discussions and policy proposals accept that fiscal discipline will not be established. Yet, instead of building an inherently controversial European Monetary Fund, it would seem natural to directly aim at national rules that are in the

clear interest of each Eurozone member country.

Is This A Competitiveness Issue?

It is often asserted that the crisis is rooted in European current-account imbalances. Indeed, a striking aspect of the Euro's first ten years of existence is deepening current deficits in some countries, matched by growing surpluses in others. As with the global imbalances issue, many observers have concluded that the problem lies with real exchange rate misalignments. With a common currency, it is claimed that many years of high, respectively low, inflation rates have led to significant competitiveness losses. This is an ominous development because it can only be corrected through higher inflation in the previously virtuous countries or through years of painfully inflation-reducing restrictive policies and sub-par growth in the deficit countries, most likely the latter.

FIGURE 1: RELATIVE UNIT LABOR COSTS (INDEX: 100=PERIOD AVERAGE)



Source: AMECO database, European Commission

Such a development has always been thought as the monetary union's nightmare scenario. It lies behind the Commission's proposals for enhanced surveillance and for the potential use of sanctions on Eurozone countries that do not take remedial action. If accepted, this proposal would impinge upon national sovereignty in the areas of price and wage setting. It would therefore be justified if market mechanisms were failing. Of course, labor markets do not always follow market logic. Governments may provoke misalignments, including setting public sector wages and labor market policies that shield large segments of the labor force from market discipline. If there is one place in the world

where there are such grave distortions, it is Europe.

But what is the evidence? Figure 1 shows the real effective exchange rates – the ratio of domestic to foreign unit labor costs – of the presumably-guilty countries since 1999, along with the evolution in Germany. It is easy to spot the gradual depreciation of Germany's real exchange rate and the real appreciation in Greece and Italy. Magnitudes also matter. In all but one case, the index remains within the 95-105 range. Given the precision of these numbers and given trade elasticities, the "ominous" evolution is really mundane. The only exception is Ireland, which underwent a large real depreciation followed by an equally large real appreciation (and where a correction is already under way). Simply put, this is a non-existent problem.

Should The Commission Be In The Driver's Seat?

Another striking feature of the crisis is the sidelining of the Commission. The debates on possible remedies take place within certain governments. The Commission puts words to the ideas mooted in Berlin and Paris, trying to put itself in charge of the policies that could follow. This is a strange evolution.

Along with the ECB, the Commission is unique in its technical capacities on the monetary union. One would normally expect the Commission to come up with solid proposals, not just during crisis times, but also in calmer periods when flaws can be identified and reform proposals assessed. Unfortunately, the Commission has boxed itself in an impossible position. It has interpreted its role as Guardian of the Treaty as rigorously implementing the Stability and Growth Pact. As a result, it has become associated with all the bad aspects of the pact.

In fact, the Commission seems unwilling to disagree with powerful governments on matters of governance. Along with endorsing what governments had previously announced, its September 2010 report includes interesting but toned-down proposals that governments have ignored. This means that ministers and officials are not provided with critical views and innovative alternatives. Therefore, much of the current morass is due to groupthink.

It is perfectly understandable that the Commission needs to tread carefully on central issues. Yet it is an independent body. At this dangerous juncture, it would help if it were using its important intellectual resources to produce original analyses, especially as governments are driven by domestic considerations.

An Opportunity To Deepen Integration

One interpretation of recent policy responses is that crises offer unique opportunities to transform existing arrangements. In this view, the unprecedented bailouts offer

a unique chance to take a definitive step towards some form of fiscal federalism as a way of making what the late Padoa-Schioppa called "a currency without a State" less of an oddity. This is an audacious bet. As any bet, it holds great potential rewards but also risks.

The rosy scenario sees the European Financial Stability Fund being transformed into a sort of European Monetary Fund. This fund would have its own resources and the ability to lend to governments, subject to conditions that inevitably restrict sovereignty at times of crisis. In order to limit incentives to require external help, a strengthened Pact would see to it that governments behave in a responsible way, another step that would strengthen the "centre", possibly the Commission – and limit the room for misbehavior by national governments. The European Monetary Fund would issue European bonds, guaranteed by member states, a sort of "federal" debt. The Euro would finally have the germs of a State.

The less rosy scenario involves policy discussions which could drag on and prove to be divisive. Markets will conclude that these discussions are leading nowhere and that the Eurozone still does not have a plan to deal with the pressing situation faced by several of its member countries. Bailing out Greece and Ireland, possibly Portugal, is one thing. Bailing out Spain and Italy requires funds of a higher magnitude. An emergency request to increase the size of the European Financial Stability Fund will trigger strong negative reactions from wary German taxpayers. The only remaining support will come from the ECB, leading to a large-scale Euro sell-off. Acrimony will rise and the end of the Euro will be in sight.

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