Why the Euro Isn’t Finished

Posted by John Cassidy

If there’s one thing practically everybody seems to be able to agree upon, it is that the euro is destined to collapse, and with it the great post-war vision of European integration. Whether you listen to newspaper columnists, financial bloggers, Wall Street analysts, or hedge-fund managers, the message you hear is the same. All these efforts to save the euro are ultimately doomed. They might as well give up now, let it crash around them, and start over.

Take the reaction to Friday’s news that seventeen of the twenty-seven countries in the European Union have agreed to forge closer economic ties, with more centralized control over the tax and spending policies of individual governments, and nine of the ten other countries have agreed to consider such a move. (Britain was the sole country to reject the idea out of hand.) The reaction fell along familiar lines: too little, too late; a Band-Aid where surgery is needed; yet another effort to kick the can down the road. (Mastery of stale metaphors appears to be a necessary qualification for Wall Street analysts.)

Up to a point, the skeptics have a point. Friday’s deal doesn’t tackle the issue at the heart of the continent’s problems, which is the same issue in all debt crises: bad debt. But the decision to move closer to a fiscal union is another important step in creating an institutional framework for resolving the fundamental issues. While the crisis isn’t going to end next week, or next month, the outlines of a long-term solution are coming into view. Whether there is time for this solution to play out hinges crucially on the European Central Bank, which is the other key player in this game of governments versus markets.

When it comes down to it, the euro zone has two problems, which have been clear all along: a solvency problem and a liquidity problem. The governments of several peripheral countries—Greece, Portugal, Ireland—have issued debts they can’t hope to pay back. (Insolvency.) And the governments of several core countries—Italy, Spain, and even France—have debts big enough that in a crisis they could find difficulty rolling over their existing bonds and issuing new ones. (Illiquidity.)

In the past couple of months, the moment of crisis has arrived. With investors shunning most European bonds, countries like Italy and Spain have seen their funding costs soar to unsustainable levels. As always happens in big financial crises, a self-reinforcing spiral has come into effect, which threatens the entire system: buyers get scared, which causes prices to fall, which scares off more buyers, which causes further falls in prices until the market virtually freezes up.

To bring the debt crisis to an end, the European governments will ultimately have to deal with the solvency problem, which will involve further restructurings and write-offs. Until recently, there was no mechanism to do this. Every time Greece or Ireland wanted a bailout, they had to deal with all the other E.U. members, who can seldom agree on anything. In the past few months, though, the Europeans have set up two bailout funds: an interim European Stability Mechanism and a permanent European Financial Stability Facility, which will start operating in July, 2012. Through these institutions, the E.U., together with the International Monetary Fund, will have the capacity to further restructure the debts of the heavily indebted peripheral countries.

But that is going to take time, and it hinges on stabilizing the situation in solvent but illiquid countries, such as Italy and Spain, and preventing the contagion from spreading to other countries, such as France. This is where the European Central Bank comes in. For only it has the ability, through its capacity to create money and spend it on financial assets of its choice, to reverse the self-fulfilling “run” on the debt markets of Italy in particular. If the E.C.B. said tomorrow that it was committed to acting as the buyer of last resort in the bond markets of euro-zone governments that are fundamentally solvent but which face short-term funding issues, the crisis would recede.
Until now, the E.C.B. has resolutely avoided saying anything like this, giving the upper hand to hedge funds and other institutions that are busy shorting euro-zone debt. This is partly because the European Union treaty that set up the central bank doesn’t anywhere mention it acting as a lender of last resort to member governments. (The E.C.B. does act like a lender of last resort to European banks. Earlier this week, it expanded these lending facilities.) But the main thing that has held back the E.C.B. is a desire to force member countries to deal with their own problems, particularly irresponsible ones like Greece and Italy.

For the past couple of months, a game of chicken has been playing out in which the markets and the troubled governments have been pleading with the E.C.B. to step in, and the E.C.B. (and Germany, which holds an effective veto on its actions) has been saying that it first wants to see real commitments to reform.

What hasn’t been fully appreciated, particularly on this side of the Atlantic, is how significant those commitments have been. In Greece and Italy, we have witnessed ineffective but democratically elected governments replaced with national-unity governments headed by technocrats committed to fiscal austerity. In Spain, too, a new government has come to power and promised not to let up in the drive to cut spending and deficits.

The other thing that the E.C.B. and Germany wanted was a Europe-wide commitment to fiscal discipline, and that is what Friday’s agreement in Brussels delivered. In future, countries that run large budget deficits will face automatic sanctions unless they can persuade a majority of other member states to exempt them, which won’t be easy. Hence Angela Merkel’s verdict: “The breakthrough to a stability union has been achieved.”

We shall see about that. Much now depends on the E.C.B., which is emitting mixed signals. On Thursday, Mario Draghi, its Italian head, seemed to downplay the suggestion that it would now step up its bond purchases. But on Friday he hailed the new agreement as “a very good outcome for euro area members” which would “be the basis for a good fiscal compact and more disciplined economic policy in euro area countries.”

After all that has happened, I cannot believe that the E.C.B. will simply stand pat and allow the bond traders to bring down the euro. Some critics portray it as a remote, out-of-touch institution that cares about but one thing: price stability. That is going too far. Draghi, an Italian who holds an economics Ph.D. from M.I.T. and spent three years working at Goldman Sachs, is a moderate technocrat rather than an ideologue. Just as important, the two new German representatives on the board of the E.C.B. are both close to Merkel, and can be expected to do her bidding.

I don’t expect any dramatic announcements next week from the E.C.B. That would look too much like it was buckling to the politicians. But over the coming weeks and months, I expect it to step up its bond purchases, both through its Securities Markets Program and, eventually, through a policy of quantitative easing that mimics what the Fed has done here. If this happens, other buyers should return to the continent’s stricken bond markets, and yields should go down, easing the immediate crisis.

Such a turnaround wouldn’t solve all of Europe’s problems, but it would buy the E.U. some more time to tackle them. In concert with further restructuring of the debts of places like Greece and Ireland, the continent’s big banks are going to have to be properly recapitalized, possibly via a European version of the TARP. And in order to head off a lengthy and grinding recession, the governments of the less affected countries, notably Germany and France, are going to have to boost demand by introducing a fiscal stimulus. (Quantitative easing, by lowering the value of the euro from its current overvalued level, would help with this, too.)

None of this is going to be easy. It is going to be a long, hard grind, and along the way there is always the possibility that confidence in the markets will evaporate completely, prompting a crisis that would prove the skeptics right. If the E.C.B. fails to play its allotted role, such an outcome is highly likely. We shouldn’t underestimate the possibility of disaster. But nor should we underestimate the commitment of the European countries, and especially Germany and France, to muddle through and hold the euro zone together. They’ve done it so far, and made more progress than many give them credit for.

Keywords

- European Union;
- euro crisis;