A self-inflicted crisis
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As the euro crisis unfolds, it is becoming more and more obvious that this is a self-inflicted crisis, one made possible by systematic mismanagement by the European leaders.

We now start to understand that financial markets in a monetary union can force individual governments into default, even governments that are willing and capable of servicing their debt. It is sufficient that investors fear some payment difficulties for a devilish dynamics to be set in motion in which government bonds are massively sold, creating a sudden stop in liquidity provision and making it impossible for governments to service the debt without outside help. Thus, fear and panic can in a self-fulfilling way drive countries into default. Fear and panic are now the driving forces in the eurozone, splitting the area into two situations, pushing some into bad equilibria characterised by austerity and recession, and others into good equilibria allowing their governments to borrow at almost no cost.

Even today the European Central Bank does not seem to recognise this problem. As a result, its strategy has been to wait and see. Thus, last year it waited until the sovereign debt crisis had sufficiently damaged the banking system and risked provoking an implosion. As it approached the precipice, it decided to act and to provide massive amounts of liquidity to banks that were a multiple of what would have been necessary had the ECB acted earlier. Today as the eurozone is hanging once again over the precipice, the ECB is sitting on the sidelines waiting for worse to come.

The problem with this strategy is that immense damage is being inflicted on confidence in the sustainability of the eurozone. With each new crisis, existential fears about the future of the eurozone become more intense. Nothing undermines the stability of the eurozone more than the growing fear that it has no future. And the ECB, which is the only institution that could calm these fears, is doing nothing. Existential fears are thus allowed to do their slow destructive work of undermining the eurozone.

The European Commission has shown an equal capacity of mismanaging the crisis. Pushed by the creditor nations and the panicky financial markets, it is forcing eurozone countries to accelerate austerity measures in the midst of a recession. As a result, the debt-to-GDP ratios increase as the denominator in this ratio is shrinking faster than the numerator. Countries end up with a higher debt burden, which triggers more panic reactions in the markets.
Again there is a failure to understand what is going on. The excess debt accumulation in the South is matched by an excess accumulation of claims in the North. The correct response would be to force the deficit countries to reduce spending and the surplus countries to increase spending. The European Commission’s strategy, however, forces all the adjustment on the deficit countries without imposing a symmetric and opposite adjustment on the surplus countries. As a result, the eurozone is forced into a deflationary straitjacket.

This strategy is doomed to fail, as those who are subjected to the deflationary treatment show symptoms of rejection. It also leads to antagonism and conflict within the eurozone. Southern countries are set up against the Northern creditor countries. The European Commission, which should promote the interests of the system as whole, has become the agent representing the interests of the creditor nations. Instead of unifying the eurozone, the European Commission is contributing to disunity and conflict.

The correct response to the crisis consists of three elements, each of which is essential. First, the ECB should step in to stop panic and fear from undermining the stability of the eurozone. It can do this by announcing that government bond rates of solvent but illiquid nations (Spain, Italy, Portugal and Ireland) will not be allowed to exceed a certain level (say, 300 basis points above the German government bond rate). The ECB is the only institution that can guarantee this, and that can stop the spread of existential fear that is destroying the eurozone. The EFSF (European Financial Stability Facility) and the future ESM (European Stability Mechanism) have limited resources and cannot credibly commit to such an outcome.

Second, the European Commission should tell deficit and surplus countries alike to make the necessary adjustments. For the deficit countries, this means austerity, albeit spread over a longer period. While the European Commission travels to the deficit countries and preaches austerity, it should also go to the surplus countries and urge them to stop trying to balance the budget when the eurozone risks moving into a recession. The European Commission’s message should be that budget deficits in these countries are good for them and for the system.

Finally, a budgetary union is a key ingredient of a sustainable monetary union. A budgetary union, however, is a long-term project. There is little prospect of achieving it quickly. What can be done quickly, however, is the issuance of common Eurobonds. This approach has the merit of signalling to the market that irreversible steps towards budgetary union are being taken today, thereby assuaging the existential fears that are destabilising the eurozone. Clearly many problems will have to be overcome in order to launch Eurobonds (see Gros, 2012), but the approach outlined above has the merit of at least starting a process that is unavoidable if one wishes to maintain the euro.

Reference