How the Eurozone will be resolving its crisis

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The political economy of the Eurozone is based on three pillars: lies, loopholes and fudges.

Back in the 1990s, its advocates made a series of mostly inconstant promises. The Germans were promised that monetary union would not give rise to fiscal transfers and would create a currency at least as hard as the Deutschmark. The French understood the euro as a vehicle to cement Europe's global reach. For the Italians and the Spanish, it offered an opportunity for monetary stability and permanently low interest rates. Especially in countries with highly deregulated banking systems, like Spain and Ireland, it brought sudden wealth by way of a housing bubble.

The various inconsistent promises were reflected in the Eurozone's governance regime. Fiscal policy co-ordination was reduced to a series of budget rules. The most important was the Maastricht Treaty's famous 3% ceiling –the maximum permitted annual deficit in relation to gross domestic product. The fundamental operating philosophy consisted of the notion that monetary and fiscal discipline was both necessary and sufficient for long-term sustainability. The independent European Central Bank (ECB) would ensure price stability. The stability and growth pact, now an integral part of the European Treaties, would enforce fiscal discipline. And that was it.

The lies, loopholes and fudges gave rise to another trinity: No-Exit, No-Default, and No-Bailout – a logically inconsistent set. While the No-Bailout pledge was explicitly enshrined in European law, the No-Exit principle is a more indirect consequence of the Treaty. There is simply no procedure for it. The only formal exit procedure is the nuclear option of a complete withdrawal from the European Union. The No-Default principle is not in the Treaty, but it was a consequence of the fact that the ECB accepted everybody's collateral on the same terms.

And then came the crisis.

Even if it is seen as a fiscal crisis today, it was not a fiscal crisis in its origin. The cause, as we understand it today, was a collision of macroeconomic imbalances with a badly regulated and undercapitalised banking system. German banks intermediated German savings surpluses into Spain and Ireland, creating housing bubbles on the way. At the height of the imbalances, in 2008, Germany

ran a current account surplus of 8% of GDP, and Spain a current account deficit of 10%.

It was not a fiscal crisis then. Spain and Ireland ran fiscal surpluses for most of the last decade. Both countries were considered fiscally righteous. Portugal ran deficits, but its debt-to-GDP ratio was only a little higher than that of France and Germany. Greece was the only country in the Eurozone's periphery that produced a classic fiscal crisis. In the year 2009, the country ran a deficit of 15% of GDP.

The policy error that turned a crisis of financial imbalances into a fiscal crisis was the response to the collapse of Lehman Brothers. The Eurozone's leaders met in October 2008, and decided that each country would guarantee its banking sector. If Eurozone leaders had set up a Eurozone-wide rescue fund, accompanied by a bank resolution regime, there would never have been a fiscal crisis in the Eurozone, except in Greece.

Subsequently, the Eurozone's leaders committed the error of focusing on the symptoms rather than the causes. Nobody wanted to let go of the self-deception, according to which fiscal stability was supposed to be a necessary and sufficient guarantor over overall systemic stability. You still hear elderly German professors and central bankers talk about this crisis in terms of fiscal profligacy alone. And if you believe that profligacy is the cause of the crisis, then surely austerity must be the answer. And that is why each crisis resolution programme has turned out to be a fiscal austerity programme, no matter whether fiscal policy was at the root of the crisis or not.

How is this crisis likely to be resolved? When they agreed to the first Greek loan programme in May 2010, officials from the European Union and the International Monetary Fund believed that Greece may just pull through on the basis of austerity and economic reforms alone. A year later, a consensus has emerged that the Greek public sector debt is not sustainable, and that Greece will probably have to default on its debts.

This is where it gets extremely messy. Angela Merkel famously pledged that all bonds would be safe until 2013. The German chancellor agreed on this formula with French President, Nicolas Sarkozy, during their infamous walk on the beaches of Deauville in France in the autumn of 2010. The idea was to roll over the indebted countries of the Eurozone periphery until 2013, point at which they would either be determined solvent or not. In the latter case, the remaining private investors would take a hit.

But political developments in the creditor countries have thrown that strategy off-course. The election success of the True Finns and an increasingly eurosceptic Bundestag have been reducing the list of feasible options. The Germans in particular now want the private sector to share the costs, to the horror of the ECB, which believes that such a scheme would bring about a collapse of the Eurozone.

One option under discussion has been a more or less voluntary maturity transformation, under which the short-term bonds would be exchanged for securities with long maturities. A voluntary restructuring is, of course, an oxymoron. The idea is to get a group of large investors into a room, and bang heads. Genuinely voluntary schemes are rarely sufficient. A forced debt exchange, however, would almost certainly lead to sovereign downgrade by the rating agencies. Such a debt exchange offer was tried before, in Argentina. Its failure accelerated the country's messy default in 2001.

Voluntary debt rescheduling can work in countries, which are considered solvent, but also facing a temporary liquidity squeeze. That is not the case in Greece. In Greece, the debt-to-GDP ratio is projected to reach 160% in 2012. The situation is so serious that half-measures are possibly the worst of all options. If you default, do it properly. A default with a 50% haircut, or more, is probably what it would take to make its debt sustainable again. The country would still require significant fiscal and economic reforms to pull through. It is after all the purpose of the exercise for Greece to remain in the Eurozone. That means it cannot benefit from a currency devaluation.

The only benefit of a voluntary scheme is that it may help the creditor countries politically. Without it, the parliaments of northern Eurozone member States may never agree to a second loan package for Greece. They want to share the costs with private investors.

So where are we headed now? I would expect that the Eurozone governments and parliaments will accept a second Greek loan package, after much noise, either this summer or in the autumn. The first package was too optimistic in terms of deficit reduction, and the impact of austerity on growth. The new package is supposed to secure Greek public finances until 2014. I would expect that Ireland and Portugal would also come back for more money, and that the inadequacy of the second Greek loan package will also become apparent next year because it relies on unrealistically high privatisation receipts. Who after all is going to buy Greek assets at a time like this?

If the second loan programme proves as insufficient as the first, there will be massive pressure from German and Finnish Eurosceptics to let Greece default. But I would assume that when faced with the straight choice of a Greek default and another small loan, political leaders will choose the loan. Default would cut the country off the capital markets for several years. It would risk contagion. It would require a recapitalisation of the ECB, and trigger immediate transfer payments under the rescue umbrellas. My hunch would be that political leaders will be just as reluctant to accept default in 2013 as they are today. They will give Greece, Ireland and Portugal another bridging loan. By 2015, a large chunk of the peripheral debt will be held, or guaranteed, by the EU creditor nations. Collective action clauses, investor bail-ins, all of that will be irrelevant. There will be no private sector left to bail-in. The private sector will have bailed out by then.

This alone will not make Greek debt any more sustainable, but it allows flexibility in the debt management. The loans may be extended to 50 years, and the interest rate may be cut towards zero. *In extremis*, you could envisage a perpetual zero-coupon bond –a debt instrument that pays no interest and that will never get repaid.

Once the European Union's crisis resolution mechanism ends up with all the periphery debt, its own bonds will serve as a proxy for periphery debt. Over time, I would expect that the European Council will extend the size and remit of the crisis mechanism from a mere backstop towards a proper debt agency, which will gradually absorb all debt. Even Spain may eventually come under this umbrella. On my calculations, Spanish house prices have a further 20 to 30% to fall, and so will real incomes. It will happen slowly, and it may take over a decade. But it will wipe out large chunks of the country's savings banks sector.

If Spain were ever to require an EU credit, the focus will shift to Italy. I suspect that Italy will not be willing, or able, to honour its bailout commitments in that case. And once Italy defaults, I cannot see Germany and France willing to bankroll the entire system unilaterally. At that point, the intra-governmental approach will break down, and the Eurozone will face a straight and extreme choice: a jump into a political union, or a breakup. The former would include a common Eurozone bond with a small fiscal union and a centralisation of all banking policies, including bank resolution policies and joint supervision. My guess is that they will choose the political union. But this is far from assured.

Would a political union be a good outcome? Think of it this way: the Eurozone would survive in one piece; there would be no blood on the streets, just a once-and-for-all, albeit reluctant bailout, accompanied by a still very limited fiscal union. It will be relatively cheap, too. Even my maximum estimate of a bank recapitalisation volume of €500 billion is still less than 10% of the Eurozone's GDP. This should be manageable –on aggregate– since the Eurozone has a lower debt-to-GDP ratio than both the UK and the US. But it might not be manageable for each country if it had to sort out its own problems. We can resolve the crisis at Eurozone level, or through default, but not through an intra-governmental insurance, as we do now.

There is, I admit, a non-trivial possibility of a big game-changing accident. Ms Merkel may be serious about the Deauville commitment, but a revolt in the German or some other parliament may force a messy premature default. Yet another accident would be political panic attack in Athens, or a realisation that the Spanish savings banks are in much worse shape than recognised, or a possible downgrading of French sovereign bonds. The list of potential accidents is long. They share a joint theme, serial political crisis mismanagement. If any of these accidents happen, the Eurozone might trigger a financial crisis bigger than the collapse of Lehman Brothers.

My best guess is that they will try to avoid such a calamity, that they will fudge until they reach the point of unfudgeability. Eventually they will have to make a choice, but I would bet that this job will have to be made by another generation of political leaders. They will have to confront a truth economic historians have known all along: that you cannot have a monetary union without a political union.