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Thinking ahead for Europe

The Eurozone Debt Crisis: From its origins to a way forward

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Abstract

The Eurozone debt crisis has now reached a turning point. This paper argues for a more organised intervention by the ECB to stop contagion through the creation of a quantitative easing programme, coupled with a political agreement among member states on a more federalist budget for the Eurozone.

The roots of this crisis and how institutions have repeated some of the mistakes of the Argentine crisis, both in 1998 and 2010, are considered in this Policy Brief. The author analyses the reasons why the ECB should start a quantitative easing programme to contain government bond yields, and shows that it can be done with limited impact on inflation targeting policies. The importance of reinforcing the new policy announced by the ECB, which has lain rather dormant during the Eurozone crisis, is also highlighted as a pre-condition for a broader political agreement on more harmonised fiscal policies and to stabilise market conditions. Responses must be organised on three levels: institutional competences, monetary policy support, and fiscal policy coordination.

Introduction

As the government debt crisis in the euro area unfolds, its sparks panic on alternate days in financial markets and a degree of resentment among EU member states. The risk that the crisis will persist and impede growth in the whole euro area is fairly high. Caution should guide the actions of European institutions in implementing exit strategies, because in a general downward economic trend the risk of 'fire sales' of assets and public finance deterioration may undermine any commendable privatisation and liberalisation effort (Manasse, 2011; Gros, 2011). In these conditions, liquidity problems may easily become solvency issues and spread among Eurozone countries (via so-called contagion effects). From the outset, European governments have believed that the sovereign crisis was a mere short-term liquidity problem, which has caused political deadlock among member states. Responses so far have not been able to stop the contagion or propose long-term strategies to fill gaps in competitiveness and growth. 'Kicking the can down the road' has contributed to the widespread belief that the crisis was somehow a temporary problem unconnected to the broader political project of the Eurozone.

Sounder long-term proposals for a revised setting of institutional competences and powers need to be brought to the table for the Eurozone. The ECB could play a key role in this new institutional framework. Responses must be organised on three levels: institutional competences, a onetary policy response, and a fiscal policy response.

Fiat lux

Let us go back a few steps. The sovereign crisis has many policy and institutional aspects in

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common with the Argentine crisis that culminated in default in 2001. In the Greek case, even economic indicators seem to be following the same path, with a stunningly similar timeframe but, of course, a different intensity (see table below).

Table 1. Main macroeconomic indicators (5 year average)

	5y average	
	Argentina	**Greece**
	1996-2000	2006-2010
GDP growth	3.2%	0.7%
Current Account (%GDP)	-3.7%	-12.3%
Unemployment	16.7%	9.4%
Public deficit (%GDP)	-2.9%	-9.45%
Public debt	40.1%	118.1%
Deposits flight (change in bank deposits last 12 months)*	-7%	-10%

* For Greece the period is Apr.10-Apr.11, for Argentina Dec.00-Dec.01.

Source: Alcidi et al. (2011).

The two countries went into insolvency for two different reasons, however. Argentina chose parity with the dollar to face the hyperinflation that put the country under severe strain during the 70s and 80s and, – thanks to the currency board – inflation came down drastically to a single digit in only a few years. Inflation had been a longstanding issue in Argentina since the decision in the 70s to devaluate the currency by over 100% in order to boost the economy (the so-called 'Rodrigazo's measures'; see Escudé 2002, 2006), while the world was entering a profound oil crisis. Thus, the currency board at the beginning of the 90s again gave some credibility to the economic and monetary policies of Argentina and the country soon regained access to financial markets.

For its part, Greece entered parity with the euro as part of a broader political project to push financial integration across Europe (first leg), to be eventually followed by more harmonised fiscal policies capable of pursuing complementary economic integration (second leg). As a result, the centralisation of monetary policies to the ECB moved the issue of credibility straight on to national fiscal policies. Greece has always had a fairly closed and corporatist economy in which a crucial source of economic initiative came from public overspending. The crisis has only rendered this situation more unsustainable.

As fiscal policies in both Argentina and Greece have failed to gain credibility over time, by not being able to minimise the negative effects of strong monetary policy decisions, capital and deposits have flown into similar investments (but in the same currency) outside the country (in the case of Greece) or more simply into the parallel currency (the dollar for Argentina). Both countries also experienced a very low level of foreign investment,[1] largely due to the concurrent devaluation of neighbouring countries' currencies in their regional areas (respectively, Brazil and Turkey), and to aspects of traditionally corporatist economies.

As with Argentina, the Eurozone debt crisis is seeing exit strategies being implemented by international organisations, with a similarly questionable level of institutional and political support that contributed to Argentina's serious troubles and eventual default.

On Argentina, the IMF courageously concluded:

> Indeed to the extent that the currency board arrangement encouraged the build-up of balance sheet mismatches, an earlier exit (e.g., in 1992-94 or in 1996-97) would have been preferable. Such an exit, had it been undertaken sooner, would not have been painless, but it would likely have been less painful than what actually occurred. This illustrates the importance of an appropriate macroeconomic policy mix and, more specifically, **an exchange-rate regime that fits a country's economic and political realities** (*emphasis added*), (IMF, 2003, p. 70).

And again:

> In the end, the Fund chose to continue to provide financing in the hope that the government would deliver on its commitments and that confidence and growth would return – in effect, allowing the authorities to "gamble for redemption". While this strategy – when adopted in early 2001 – might have **succeeded in a more favourable external and political environment**, by mid-2001 the chances of success had become

[1] This was a structural issue for a closed economy such as Greece, while for Argentina it gradually became an important issue as the economy started to decline.

> minimal. At this stage, the provision of significant new financing only postponed the inevitable and, by raising the debt burden, also meant that the costs of the eventual collapse were all the greater, (*emphasis added*). (IMF, 2003, p. 67).

Both in Argentina and the Eurozone, broader political decisions – such as the drastic reduction of historically high inflation and promoting financial and economic integration, respectively – have not been sufficiently supported over time by correct monetary policy decisions and complementary fiscal policies. The decision to issue debt in a currency that the issuing country cannot control comes at a cost (Kopf, 2011), which in both cases was underestimated in a period of growth, by not establishing financial stability mechanisms and exit procedures to be used as threatening measures to promote fiscal adjustments. Argentina has also taught us that austerity measures cannot be implemented without a plan for investment on long-term key drivers of the economy to avoid downward pressure on the economy. As a result, wrong decisions at the fiscal and monetary policy levels have reinforced each other, locking these countries in to a brutal spiral of disruption.

In other words, as a result of hard-pegged exchange rates, both countries had seen a gradual deterioration of their public finances and general economic conditions, due to capital mobility and global market events (the financial crises of 1998 and 2007).

A 'game change'

With the benefit of hindsight, the objective for EU policy-makers today is to succeed where the IMF failed with Argentina, avoiding the implosion of the Eurozone and the return of Greece and other countries to a variable exchange rate to facilitate fiscal adjustments. The decision in 1998 to fix exchange rates without introducing exit procedures[2] and mechanisms to support imbalances (through a roadmap to create harmonised fiscal policies), carries a high price. However, the Eurozone is a political decision that comes from the willingness of European citizens to have a common currency and boost economic and financial integration. The political project must therefore be preserved.

To define a response at institutional level, the role of key institutions, such as the International Monetary Fund, must be carefully assessed. The IMF has offered financial aid to Argentina and Greece to support a decision (the parity with the dollar and the creation of the Eurozone) made by governments and not by central banks. In effect, the political role of the IMF in this and the Argentine crisis may be an intrinsic problem. Monetary funds are generally tools designed to work with short-term liquidity funding problems and therefore the conditions attached to the intervention as lender of last resort must be based on short-term monetary policy issues, rather than long-term fiscal and political objectives.

> There was not sufficient attention paid to the fact that the structural reforms that were seen as critical to growth had largely stalled. Fiscal policy assessments were not based on an adequate appraisal of the risks to debt sustainability in the event of a slowdown in growth. (IMF, 2003, p. 71).

And again:

> [..] **in a situation in which the debt dynamics are clearly unsustainable, the IMF should not provide its financing**. (IMF, 2003, p. 72).

The lesson from that failure was that the IMF should only intervene when the three conditions below are met:

1. A short-term liquidity problem, rather than a long-term solvency issue;
2. The country's 'lender of last resort' (central bank) does not have enough resources to tackle the liquidity crisis; and
3. Intervention must be conditioned to a change in the monetary policy of the beneficiary.

In the case of Argentina, the condition for the IMF intervention could have been the exit from the parity with the dollar, which was clearly unsustainable (at least a few years after its introduction), rather than supporting decisions made by governments (with its official blessing). Likewise, the fund should have not intervened in

[2] The exit of one or more countries may risk contagion effects and turn out to be unworkable for procedural reasons (Eichengreen, 2007, 2011). For instance, in the process of redenomination of all contracts in the new national currency, the country may need to block capital outflows as the fear of devaluation will push people to shift all remaining deposits and assets into other euro area countries.

the Eurozone crisis and taken on the ECB's role of lender of last resort. The sole condition for the intervention in the Eurozone crisis should have been to help Greece and its central bank to exit the euro area, providing funding and jointly defining a new exchange rate around its economy and competitiveness. The IMF has thus implicitly decided to support, with the funding of Eurozone member states, a situation fed by a political impasse. The idea of being able to solve a long-term structural political problem through short-term funding relief, such as the IMF or similar tools (e.g. the EFSF) linked to austerity fiscal measures, is questionable. Long-term fiscal problems and competitiveness issues should be the prerogative of other supra-national institutions – such as the World Bank and the European Commission (for the EU) – with the independent support of central banks, by setting the right framework for fiscal policies to be most effective.

A quantitative easing for the euro area

As the public debt situation becomes more intricate and complex, the ECB (and the Eurosystem) – with the recent decision to buy consistent amounts of government bonds and after the tacit approval of France and Germany – has taken on the role of lender of last resort to finally respond to the gravity of this crisis (ECB, 2011). The ECB acknowledges that by allowing 'selective/restricted defaults', contagion effects would most likely spread among euro area countries and, with no support for the implementation of austerity measures, pressures from public opinion would gradually lead those countries to quit the Eurozone and adjust exchange rates, with all the unpredictable consequences this would have.

In effect, the ECB has so far been defending the supposed inflation targeting (in)action at the cost of breaking up the Eurozone and creating intolerable social conflict and economic disparities. The existence of the Eurozone itself should come before price stability. The ECB intervention would therefore not have to save a political project but rather to support countries that have been hit by losing control of monetary policies.

The ECB, as emergency backstop of the Eurozone, should therefore have intervened from the beginning to stabilise the Eurozone secondary markets for government bonds, to avoid the clashes of a tough political arena, and most important, to make sure liquidity issues would not rapidly turn into solvency crises. A political impasse has slowed down interventions (even those with small numbers in comparison to the Eurozone GDP and government revenues) by subjecting each bail-out programme to heavy political (and public opinion) backfire from funding countries and injecting uncertainty into global markets.

As long as the Eurozone refrains from deploying all its potential resources to make markets believe that countries are doing everything possible to avoid default, the situation will not stabilise (Zingales, 2011).

The decision to buy bonds in the market may not be enough. The Eurosystem should therefore stand ready with immediate effect to contribute with a quantitative easing (QE) programme to purchase government bonds of the euro area in the secondary market, in the same way they racked up the financial crisis covered bonds from financial institutions during the crisis to stabilise the money market and then real interest rates. The ECB should disclose the amounts and modalities of the auctions of its Securities Markets Programme. In effect, the intervention of the ECB would be a natural thing, as it should be one of its objectives to participate and support the sovereign bond secondary markets, as lender of last resort in emergency situations (De Grauwe, 2011), in which markets have lost confidence that current solutions (EFSF and ESM) and political support will be able to rescue huge Eurozone debts, such as the Italian one. The central bank action should resolve the coordination issues among member states that create instability in financial markets, high volatile patterns and a potential freeze in the interbank money market.

Finally, competing QE programmes, such as those of the UK and the US, also contribute to the appetite for lower risk Eurozone bonds among international investors, as they may see markets supported by own central banks as being safer.

Two classical objections to a QE

The two classical objections to a QE by the ECB are the risk of moral hazard by member states, and the risk of deviation from the price stability mission set out in the ECB statute and the European Treaty (TFEU, Art. 121.1).

The moral hazard problem, as with financial institutions, is a problem of supervision and monitoring costs. In an institutional setting such as the Eurozone, formal control over member states' new issuances can be carried on jointly by the European Commission and the European Central Bank. Procedures must be designed to impose – on countries benefiting from a QE programme – a formal approval for new emissions by the ECB and Commission in case no austerity measures have been implemented. Additional sanctioning measures can be imposed through cutting resources pumped into the economy of the troubled country to support austerity measures. In this way, European institutions would also exercise a stricter indirect control on national fiscal budgets (see below, final section). The ECB will only intervene to support secondary markets and bond yields.

The impact of a QE on the price stability mission must be assessed from a legal and economic/financial standpoint. Legally, looking closely at the Treaty (Art. 121), the purchase of government bonds in secondary markets would not infringe the rules assigning competences to the European Central Bank and its price stability mission (Buiter, 2009), especially if the programme is backed up by greater contributions of NCBs to the capital of the ECB. In addition, another banking crisis fuelled by sovereign defaults would definitely hamper monetary transmission channels. The Eurosystem, as shown below, was already active in purchasing covered and government bonds to help financial institutions, both in 2009 and 2010 (roughly €60.87 bn; ECB, 2010).

From an economic and financial standpoint, the Eurosystem can certainly carry on a QE via several tools available on its balance sheet.[3] So far, the Eurosystem has provided liquidity to financial institutions with a net lending of €135.28 bn[4] (total lending of €505.13 bn). The average annual net interest rate[5] on its assets is 1.02%. The table below compares key items of the balance sheet of the Federal Reserve, Eurosystem and Bank of England.

At the end of Q1 2011, the Eurozone has the world's biggest gold reserve and, comparing key indicators (shaded areas) with the BoE and the FED, the Eurosystem consolidated balance sheet so far shows very low market activism, in line with its decision not to be directly involved in the sovereign debt crisis. The Eurosystem has only been active in offering repurchasing agreements ('repo') for financial institutions to support markets indirectly.

Total assets are 3.4 times gold and FX reserves, while securities held in portfolio represent only 25.76% of total assets in comparison to over 90% for the BoE and over 80% for the FED. In addition, the Eurosystem consolidated balance sheet holds only 5.45% of total outstanding government securities, and just 1.29% purchased in the last year for monetary policy purposes. The BoE and FED have proportionally more than three and two times this amount. By July 2011, the Eurosystem had purchased the government bonds of Greece, Portugal and Ireland for roughly €74 bn, plus circa €33 bn by the ECB directly.

As a result, the ECB can both increase the size of the balance sheet and adjust the assets side with very limited impact (if any) on inflation targeting policies. Expanding the assets side can be achieved with two sets of operations. Firstly, by tightening repo transactions policies (removing discretionary decisions in the application of requirements such as the 'minimum rating') and dismissing most liquid financial instruments – such as most of the €60.87 bn purchased under the Securities Markets Programme (SMP) – thereby trying to exploit up to €316.66 bn that are currently booked on the balance sheet as revaluation accounts.

[3] Interestingly, the BoE is carrying on its QE by funding an off-balance sheet fund that has the power to acquire UK gilts like other financial institutions in the market.

[4] The net lending is calculated as the difference between the total lending of the ECB to financial institutions minus all deposits held at the Eurosystem.

[5] The difference between the annual weighted average interest rate paid on deposits (liabilities) and the annual weighted average interest rate received on lending operations towards euro-area credit institutions.

*Table 2. FED-BoE-ECB key balance sheet indicators (€mn)**

	Federal Reserve	Eurosystem	Bank of England
Gold (Q1 2011) ^	261,480.86	363,250	9,975.93
FX currencies (Q1 2011)^	89,134.39	222,419.64	52,357.99
Tot.	350,615.25	585,669.64	62,333.91
Total assets	2,275,768***	2,000,471	256,502.48
xtimes Gold/FX	X6.49	x3.42	x4.12
Notes and coin (M0)	716,979	855,737	67,974
% tot. assets	31.5%	42.78%	26.50%
xtimes Gold/FX	x2.05	x1.46	x1.09
M2 aggregate	6,472,795	8,489,167	2,359,698
Government securities°	1,139,160	457,426**	224,613
Other securities	701,633	60,873	8,883
Tot.	1,840,793	518,299	233,496
% tot. assets	80.89%	25.76%	91.03%
xtimes M0	x2.57	x0.61	x3.44
Capital	35,969	81,480	5,011
% tot. assets	1.58%	4.07%	7.37%
Reserves balances (minimum and excess)	892,809	208,285	145,345
% tot. assets	39,23%	10.41%	56.66%
Govt debt (securities outstanding)	10,129,952	8,323,500	1,268,200
Govt sec held/Tot.	11,25%	5.45%**	17.71%
Interbank rates (Aug 4th)∞	0.09%	0.851%	0.54%
Nominal interest rates	0.25%	1.50%	0.50%
Excess reserves rates	0.25%	0%	n/a
Deposit Facility	0.28% (term dep. on July 26th)	0.75%	0.25%

* Updated to end July/August 2011 where not otherwise indicated. Exchange rates at end of Q2 2011 (EUR/USD: 1.4391; EUR/GBP: 0.88274; ECB data warehouse; gold price at Q2 2011; World Gold Council).

** Estimates (assuming that the Eurosystem does not hold other securities than covered and government bonds). ECB holds €33.94 bn directly and roughly other 74 €bn for monetary policy operations. The remaining government bonds are held by national central banks and may have been sitting on their balance sheet from the inception of the euro.

*** It includes gold reserves at their current value.

° Securities of their national government(s) held in portfolio or resources allocated to purchases (e.g. BoE).

^ Value at end of Q1 2011. In the US, gold reserves and receivables are usually posted on balance sheet at a price of $42 2/9, roughly $11 bn. Gold and FX do not usually generate monetary income.

∞ Federal funds rate (US), EONIA (EU), and SONIA (UK).

Sources: Author from FED, BoE and ECB database, World Gold Council, AMECO database, and Eurostat.

Table 3. Outstanding securities portfolio breakdown (top 4 euro countries; €bn)

Central bank	Securities held in portfolio	Covered bonds	Government debt
Germany	36.2	15.6	20.6*
Italy	84.4	10.1	74.32
Spain	87.83	7.39	80.43*
France	90.4	21.3	59.5
Tot.	295.83	54.39	234.85

*estimates

Source: Author from central banks' annual reports.

The table above shows the current securities holdings of the top four Eurozone central banks. In line with its official political position, and despite the fact that is the biggest economy of the Eurozone, Germany's central bank only holds roughly €20 bn in government debt. The Banque de France has the biggest securities portfolio, closely followed by Spain and Italy. Most of these government bonds have been sitting on the NCBs' balance sheets since well before the crisis began.

Additional contributions to a QE programme can also come from national central banks, which can fuel additional available resources into the capital of the Eurosystem, which is today roughly €81 bn (including past reserves), or directly into the capital of the ECB (roughly €10 bn). Tightening repo transactions policies, dismissing most liquid financial instruments, and increasing the capital contribution of NCBs' actions would certainly have no impact on price stability mechanisms.

Secondly, there are other available tools that may have an indirect but very limited impact on inflation targeting policies. For instance, the Federal Reserve buys treasuries on secondary markets (through public auctions) and typically wires funds into current accounts held by clearing house banks at the central bank. Financial institutions receiving these funds use very limited amounts because the FED gives an interest on excess reserves that is higher than the federal funds rate and roughly the same as term deposit facilities (see Table 2, above). The payment of these interests may require liquidity injections into the system, but – assuming governments will sooner or later be back on track – transactions may be sterilised by selling those securities when markets recover. For its part, the ECB does not offer any interest on excess reserves at the moment and the main interbank rate is consistently higher than the US one, the use of the same tool should therefore be coupled with actions in the interbank money market by acting on discount rates and reserves requirements. In addition, the ECB should disclose details of the QE, in particular the total amount of expected purchases and how these securities will be bought (preferably through public auctions).

The potentially deployable firepower would certainly be big enough to restore market confidence that European institutions are able to face risks of default and to sustain countries' market fundamentals in the medium term. In addition, the ECB can always use, as a 'last resort' tool, the possibility to act on nominal interest rates and expand the monetary base.

Why a quantitative easing?

The Eurosystem is already indirectly active in the sovereign bond market by financing financial institutions and by offering repo lending at better-than-current-market conditions, thereby supporting artificial market access for countries such as Greece and Portugal. By so far only accepting Greek and other public debt securities as collateral, however, the ECB has not removed the risk that it is indirectly taking on, even if it is off balance sheet. If Greece and other peripheral countries' default, in effect, there is a high chance that the European banking system will experience a profound crisis, which would freeze the interbank market and call the ECB indirectly into play by accepting losses on the collateral it is currently holding. The ECB is therefore not only providing repo money with lower-than-market-value haircuts, it is also indirectly placing implicit guarantees on the default of sovereigns. In this way, financial institutions enjoy the benefits of a potential recovery, while the costs will ultimately be borne by the ECB.

A direct intervention would create more favourable conditions for a 'game change', even though it is certainly not the only action needed to solve this crisis (see last section). In effect, a broad programme of government bonds purchases in the secondary market can have multiple effects.

1. It would stabilise market mechanisms more naturally, by minimising perverse downward market pressures and temporarily recreating more favourable market conditions, boosting appetite for risk in investors. For instance, the yields on US treasuries have remained stable and even at lower-than-expected levels when the FED announced the end of the QE2 and throughout the recent discussions about the debt ceiling, showing that the support of the central bank managed to create confidence and a risk appetite among international investors over time. Of course, this risk appetite will only be short-term if the US does not address its worrying fiscal position. Bonds must be bought through market auctions at current rates to lower haircuts towards zero, which is a typical component of government securities. Improved market conditions would also indirectly benefit the interbank market, the money market and real interest rates. Purchases must then be targeted to those key instruments ensuring market liquidity. 86% of bonds purchases by the FED are in treasuries of between 2.5 and 10 years' maturity. Finally, the ECB must disclose the size of the quantitative easing programme, as well as the kind of instruments and maturities of each purchase over time.
2. Booking government debt securities on the balance sheet of the central bank has several positive implications. First, burden sharing – through contributions by NCBs to the capital of the ECB – may allow the Eurosystem to provide more flexible and immediate responses to liquidity crises than rescue plans that require lengthy political processing through national parliaments. Second, the political pressure to apply fiscal austerity measures would be exercised by the ECB and other EU institutions on the more credible threat that the programme would stop as soon as fiscal measures stop or slow down. Third, the debt will finally sit on the Eurosystem balance sheet, which would allow more control if the country gets into liquidity troubles or succeed with their fiscal adjustments (sterilisation). Finally, it may be partially written off as a reward if the country successfully applies austerity measures and structural reforms.
3. 'Buying debt' will also slow down the pro-cyclical mechanisms of rating downgrades and limit their role in this crisis, even though it does not solve the issue of the role of ratings granted by regulators in capital requirements regulation.
4. It will limit the hold-up of financial institutions (by holding these instruments) as well as limiting their moral hazard, which remains a relevant issue with repo transactions.
5. Most important, a QE would free the European Commission of the heavy political burden to seek approval for rescue plans on behalf of member states. In effect, the ECB intervention would allow the Commission and national governments to seek broader political coordination on more fundamental issues, such as internal imbalances and anaemic growth. European institutions, such as the European Commission, would have enough time to work, in line with the Treaty, on long-term solutions to boost competitiveness and reforms in the Eurozone. This reshuffling of competences among EU authorities would also give them enough time to consider the developments in a global economy that is inexorably moving its centre of gravity away from Western countries towards emerging economies.

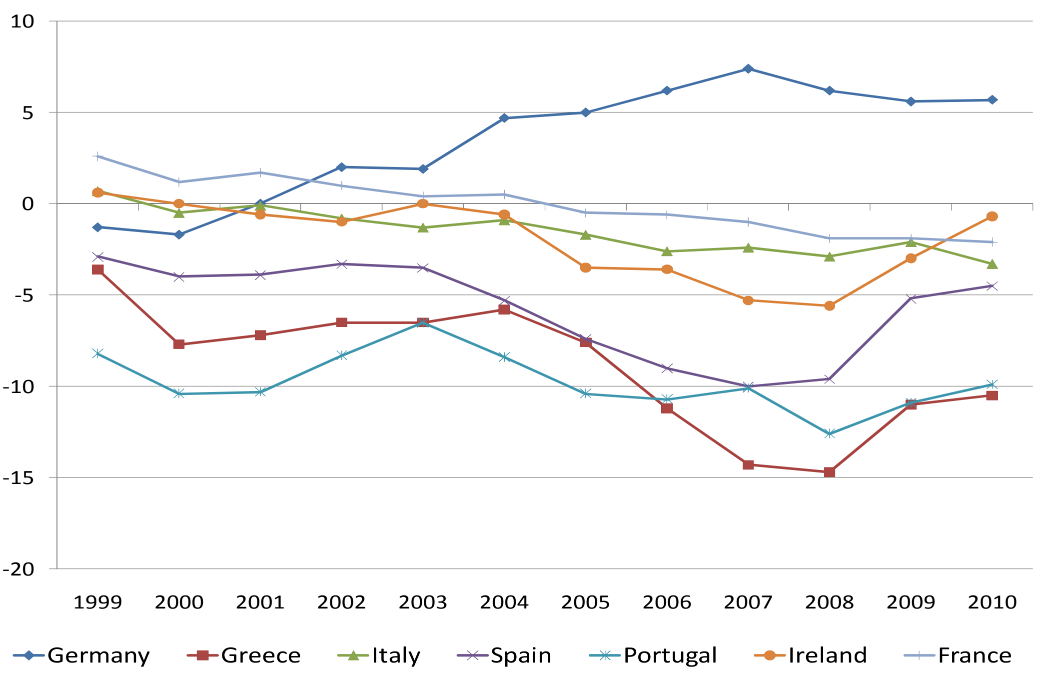
A well-designed programme can stabilise markets by signalling that the ECB is willing to relax its price stability mission to avoid the default of the Eurozone.

The way ahead: towards a more 'federal' solution

Once mechanisms have been put in place to prevent moral hazard and to ensure the ECB's independence, the decision of the ECB to approve a broader purchase programme to support Eurozone member states would stimulate member states and other European institutions to follow up this decision with fiscal adjustments, and more harmonised and federalist fiscal policies. The QE actually draws the missing link between a common monetary policy and a mechanism for more coordinated fiscal policies. Member states would irremediably not be able to bargain their burden share to sustain the euro area (as indirectly and independently done by the intervention of the ECB, with its implications for nominal and relative prices), so they would be forced to try to exercise greater control by promoting adjustments, structural reforms and austerity measures through a Eurozone budget. If they keep ignoring the ECB intervention, the central bank must stop the programme, which would plunge member states back into deep water.

Concerning fiscal policies, since its inception the common currency has boosted regional imbalances in the euro area in favour of those countries that could compete more in global markets. Countries such as Germany,[6] Finland and the Netherlands have enjoyed and are enjoying high surpluses[7] in the short term, also thanks to the euro, which has allowed them to exploit even more their long-term advantage in competitiveness over southern European countries.

Figure 1. Eurozone's current accounts balances (% GDP)



Source: Eurostat.

The figure on this page shows trends in current accounts deficit/surplus among major Eurozone countries. Not surprisingly, Germany – historically a competitive country with a high level of innovation – has immediately experienced a bounce into the surplus area (and now consistently above 5%) since the introduction of the common currency. Countries like Italy and France, on the other hand, have seen a gradual deterioration of their current account balance since the common currency was introduced.

Bail-out programmes have so far been simply short-term measures in which wealthier countries have contributed with a minimal part of their budget to strengthen the system that allowed them to become stronger. It is also undeniable that the Eurozone has supported uncompetitive countries, bringing their debt burdens into the area of apparent sustainability. In effect, this situation has created, on the one side, moral hazard by myopic governments and leaders that saw the possibility to borrow at a lower cost to finance public expenditures, rather than as an opportunity to reinforce fiscal positions and promote less popular structural reforms to fill the competitiveness gap. On the other side, structural reforms may take years and cannot be carried out only through cheaper access to markets, without the support of long-term investments programmes.

Bolder and more long-term-oriented proposals for a Eurozone fiscal budget must be brought to the table (Jutta et al., 2011). Contributions to a more federalist Eurozone budget may be supported by a Eurobonds issuance, and should also be indexed to the level of surplus that countries enjoy, primarily thanks to the common currency. A more federal budget should provide fiscal support, in particular to those countries

[6] It is also true that in the mid-90s Germany implemented reforms that blocked salaries for some years while it invested in innovation, but this does not explain the perfect timing in which the current account rose above 5% after the introduction of the euro.

[7] The recent slowdown in the global economy is currently affecting the current account balance of these countries, which still remains fairly high in comparison to peripheral Eurozone countries.

carrying out painful fiscal adjustments and long-term economic reforms, which will always lag behind in a competitive (and non-federalist) regional area. Proposals of course must be supported by stronger intervention powers with effective sanctioning systems. Reforms cannot be implemented only through austerity, but they need to be softened by investments, which will minimise the probability that the country falls into loss aversion. More specifically, loss aversion means that if the public opinion of the country under stress perceives a choice between two losses – fiscal austerity measures (loss with high probability but 'low' impact) versus the risk of being caught if you don't pay taxes (loss with low probability but much higher impact) – they may become risk-seekers, thereby pushing the country to fail fiscal adjustments (as for Argentina) quit the eurozone, and revert to a floating nominal exchange rate.

The uncertainty around the solutions that will be finally taken at the end of a long political process gives us the opportunity to elaborate four potential scenarios that may lie ahead for the Eurozone.

1. 'Dream' scenario

The temporary rescue plans (supported by the ECB until the European Financial Stability Facility enters into force) succeed in dealing with liquidity issues and pushing austerity measures. The economy becomes more open and capital inflows increases. The sustainability of public finance and confidence in the government bond market gradually return to normality. The economy returns to a level of growth sufficient to promote prosperity. There is no debt restructuring or default and the debt dynamics become more sustainable.

2. 'Pessimistic' scenario

No political support to expand rescue plans and accept a stronger ECB intervention. Greece and possibly other countries unilaterally decide to exit the Eurozone. The currency will adjust and euro-denominated debt remains until maturity, if it is not under domestic law (e.g. 90% of Greek debt is under domestic law). However, in the short term, there will anyway be a default[8] until the procedure to exit the Eurozone has been fully implemented. An exit procedure from a common currency union has never been implemented before and may take years. The country will then be officially on its own. In the meantime, this will not stop contagion effects among other EU countries.

3. 'Muddle-through' scenario

Rescue plans and temporary ECB intervention do not succeed in pushing Greece and other peripheral countries back on the track of sustainable public finances (dream scenario). The Eurozone will keep providing resources through rescue plans approved by member states until the wealthier countries decide to swithch off the tap. This situation triggers a hard restructuring or simply a default for Greece (followed perhaps by other countries, such as Portugal and Spain, in the short term). The interbank market will most likely freeze if the ECB does not intervene again. However, Greece and Portugal (as well as other potentially defaulting countries) may only decide to remain in the Eurozone in the short/medium term. Risk will certainly spread to other countries, mainly because markets anticipate the fact that there will not be enough political support (if no strong ECB intervention) to rescue countries as Spain, and Italy, for instance. As stated, market confidence in Eurozone sovereigns is built on the implicit guarantees of stronger countries. If they threaten to withdraw these guarantees, the value of peripheral sovereign debt plunges according to their economic fundamentals. Even more solid countries, such as France, will eventually suffer contagion effects. The future tensions that this situation may create would create the Eurozone to break up and to perhaps keep the common currency area only in few continental countries.

4. 'Game change' scenario

The ECB shows its muscle and decides to intervene directly in the market to solve the short-term liquidity needs with a medium-term QE programme, as discussed above. The intervention also succeeds in designing an appropriate burden-sharing among NCBs through greater contribution to capital and reserves, and it also stimulates member states to find greater coordination of fiscal policies. In effect, in parallel

[8] It may not necessarily be 'evil' for a sovereign to default. History shows that sovereign defaults are typically followed by sustained economic recovery, as in the case of Argentina (Panizza et al., 2009).

to the ECB intervention, Eurozone member states – feeling they are losing direct control on burden-sharing mechanisms in the European Monetary Union – and the European Commission decide to seek political agreement on a process of greater economic integration via a Eurozone federal budget (supported by Eurobond issuances). In the meantime, the Commission will inject new resources for long-term investments (to support austerity measures) and – jointly with the ECB – will supervise the implementation of austerity measures and predispose an official exit procedure from the Eurozone, threatening to use the procedure and stop the QE and other liquidity support for countries that do not comply. Additionally, member states will be forced to find a broad and stable political agreement by the indirect burden-sharing imposed by the independent ECB intervention. Once a more federal budget is agreed, the Commission (with the support of national governments) will elaborate a long-term strategy to boost competitiveness in troubled countries and to implement even more structural reforms and investments in innovation. Essential to this broader action is the definition of an effective mechanism of sanctioning/rewarding for 'net-receiver' countries, as well as an exit procedure from the Eurozone if sanctions are not enough.

Conclusions

The Eurozone is at a turning point. We can either sink in the mire of our debt and go back to weak national policies that will destroy the euro area, or decide to build a more integrated European economy by strengthening efforts towards more coordinated fiscal policies. In effect, monetary union has been a great tool with which to increase financial integration in the euro area, but it has not seriously addressed issues of economic integration and competitiveness. Despite high-level commitments, the original sin of the crisis lay in the decision to harmonise monetary policies without harmonising or strengthening Eurozone fiscal policies.

The way forward must be designed around three actions: redefining institutional competences among international organisations; strengthening ECB policy as 'lender of last resort' for its members; and increasing coordination among euro area members around fiscal policies.

The whole Eurozone has been built on the implicit guarantees of stronger countries. If markets feel at any stage that these guarantees may no longer be there, because certain countries are not using all possible means to avoid a default, they withdraw capital and investments in weaker countries in favour of the stronger ones or other regional areas of the global economy.

Alternatives to the two-tier long-term exit strategy (quantitative easing and a more federal budget) described above seem so far unable to tackle the financial instability and structural regional imbalances that lie behind the inception of the monetary union. The role of European monetary funds and the IMF cannot be elevated to a panacea for this crisis, as they are tools to help countries in very specific and limited circumstances. The time for endless political compromises is up. Now is the time to push our leaders to take their responsibilities by embracing a new age for the euro area that could avert an unsettling and rather painful decline.

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