Escaping Europe’s Catch 22

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The situation in early 2012 looks better than it has for a while. The European Central Bank’s (ECB) intervention in the banking sector and positive developments in Italy have increased confidence in the markets that the EU might eventually be able to overcome the crisis. But while Italy and Spain are raising additional money at much more favourable rates, the downgrading of eurozone economies continues nonetheless. The situation remains very fragile and the future looks worrying, with the International Monetary Fund (IMF) recently warning of a potentially disastrous economic downturn in the euro zone.

Europeans are increasingly wondering what more they can do. So much has already been implemented: enhanced governance in the euro zone, an increasingly interventionist ECB, austerity and reform programmes across the EU, significant support from stronger economies and the IMF to the weaker ones, repeated support to prop up Europe's banking sector, and political change in most crisis countries. But nothing has proven to be enough to stop the crisis from resurfacing again and again.

There are more attempts to stop the crisis in the pipeline, including a permanent larger crisis mechanism earlier than previously scheduled, higher firepower for the IMF, negotiations for a deal with the private sector to reduce Greek debt, and a new fiscal compact enshrined in an intergovernmental treaty to enforce fiscal discipline, preparing the political ground for Germany to support additional efforts to overcome the crisis. Implementing all this will prove to be difficult, but even once all this is in place, will it be enough?

The likelihood is that it will not be sufficient. In part, this is because some of the fundamental questions still remain unanswered: Must the ECB act as a (temporary) lender and buyer of last resort? Will the European and international liquidity net be big enough to stop contagion? How can the imbalances and the growth differential between stronger and weaker economies be addressed? Will the Greek haircut be enough to achieve a sustainable debt level by 2020 or will we witness another restructuring round this time involving institutional lenders? Will Greece and/or other problem countries be able to remain in the euro zone? And how much further must economic and political integration go?

All these questions remain unanswered and the euro zone is caught in a Catch 22 as multiple parallel crises often require contradictory responses. There is a banking crisis, a growth crisis, a public finance crisis, a divergence crisis, a market trust crisis, a governance crisis, a social crisis, a political crisis – all distinct but closely interrelated. To some extent this explains the different perspectives of politicians, commentators and economists, who are focusing on different crises. And for ‘their’ crisis certain actions might seem to be the most appropriate – but these ‘solutions’ often have a negative impact on other crisis dimensions.

This makes a permanent resolution virtually unattainable. For example, boosting growth or recapitalising banks requires an injection of public money, which aggravates the public finance crisis. Addressing the market trust issue by collateralising debt increases governance issues, generates the risk of moral hazard and raises political objections in a number of key capitals. More austerity is necessary to cut deficits, but it increases economic divergence, lowers growth and aggravates the political and social crises, leading to worse public finances and to a slowdown of reform. And so on...

Politics focuses on the most immediate crisis at hand, oscillating with every new development and even triggering renewed intensity in another crisis area. This is a battle which can’t be won – at least not in the short term.

But what offers a long-term escape from the Catch 22 in which Europe is trapped? The last two years have proven that a wait-and-see approach is no viable strategy, as the situation tends to
deteriorate if the EU/euro zone cannot get ahead and stay ahead of the crisis curve. A muddling-through approach will also not work either, as additional crisis responses always have to be bigger and more decisive than previous ones, creating more and more political resistance in both stronger and weaker Member States. Some are suggesting a catharsis, calling for Greece's exit from the euro zone. But this is a dangerous illusion, because it would not calm down the situation under the present circumstances. Rather, it would most likely negatively affect other problem countries and thus undermine confidence in the overall stability of the common currency.

But how can Europe get ahead of the curve? National reform efforts and fiscal prudence are indispensable but they do not produce a decisive break from the downward spiral. Two key additional elements are required to change the tide: a 'New Deal' to help kick-start growth, especially in the weakest economies, and a (temporary and partial) collateralisation of debt.

The sovereign debt crisis has proven that greater budgetary discipline and structural reforms are necessary. But to a large extent the crisis recipe has failed. Not only does public finance discipline fail to address the complex origins of the crisis, it is also unlikely to work should austerity continue to undermine growth perspectives in Europe's periphery, which will increase economic divergence within the euro zone even further. The euro area will not be able to endure the political, financial and socio-economic costs of bridging the gap between a strong centre and a weak periphery which, ultimately, is undermining confidence in the future of the common currency.

What is needed is a 'New Deal' for the euro, based on investment rather than transfers and linked to strict conditionality. The reduction of co-financing rates in order to speed up access to EU funds was a move in the right direction, but more needs to be done. Separate treatment of productive investment in the excessive deficit procedure, austerity programmes and fiscal consolidation plans; the establishment of a temporary investment fund – a new Stability and Growth Fund (SGF); increased use of new loan/private-public partnership instruments; public guarantees and insurance to facilitate private investment; a refocusing of the EU budget – all this would boost growth and employment in weaker economies, reduce divergence, increase the feasibility of reform and, in the end, calm markets.

In addition, the agreement on the fiscal compact could politically prepare the grounds for some kind of debt collateralisation, sending a strong signal to investors that euro countries are ready and willing to integrate further, which should boost confidence in the future of the common currency.

The proposals by the German Council of Economic Experts (*Sachverständigenrat*) based on a debt reduction strategy that seeks the gradual but compulsory reduction of government debt to below 60% of GDP is an attractive option, given that the common issuance of bonds would be temporary and used only for debt ratios over 60%. Debt exceeding this level would be pooled in a 'redemption fund'. Every country would commit to autonomously redeem the transferred debt over a period of 20-25 years, following a defined consolidation plan. In return, the fund would issue 'safe bonds', which would be used to cover pre-agreed financing needs for servicing outstanding debt and new borrowing. The 'redemption model' would be in line with EU Treaties and national constitutional requirements, which prohibit permanent collateralisation of debt.

A 'New Deal' and the partial and temporary collateralisation of debt would help to restore confidence by providing forceful responses with respect to a number of crisis dimensions. This would provide the breathing space necessary to address and overcome the remaining fundamental imbalance between economic and monetary union, which at some point in time will require a more substantial EU treaty revision.

There are some positive signs that this is where the euro zone and the EU are heading. In the meantime, Europe will have to continue to fight off crisis after crisis. But the danger is that Europe could run out of steam and attempt to simply muddle through without a decisive breakthrough and without a long-term goal in sight. If this is the case, the crisis will not just be with us in 2012 but will continue to drag down the EU until a painful but inevitable implosion with incalculable consequences for current and future generations.

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