Reversing Europe's renationalization
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Far from abating, the euro crisis has taken a turn for the worse in recent months. The European Central Bank managed to relieve an incipient credit crunch through its long-term refinancing operation (LTRO), which lent over a trillion euros to eurozone banks at one percent. This brought considerable relief to financial markets, and the resulting rally obscured underlying deterioration; but that is unlikely to last much longer.

Illustration by Dean Rohrer

The fundamental problems have not been resolved; indeed, the gap between creditor and debtor countries continues to widen. The crisis has entered what may be a less volatile but potentially more lethal phase.

At the onset of the crisis, the eurozone's breakup was inconceivable: the assets and liabilities denominated in the common currency were so intermingled that a breakup would cause an uncontrollable meltdown. But, as the crisis has progressed, the eurozone financial system has been progressively reoriented along national lines.

This trend has gathered momentum in recent months. The LTRO enabled Spanish and Italian banks to engage in very profitable and low-risk arbitrage in their own countries' bonds. And the preferential treatment received by the ECB on its Greek bonds will discourage other investors from holding sovereign debt. If this continues for a few more years, a eurozone breakup would become possible without a meltdown – the omelet could be unscrambled – but it would leave the creditor countries' central banks holding large, difficult-to-enforce claims against the debtor countries' central banks.

The Bundesbank has become aware of the danger. It is now engaged in a campaign against the indefinite expansion of the money supply, and it has started taking measures to limit the losses that it would sustain in case of a breakup. This is creating a self-fulfilling prophecy: once the Bundesbank starts guarding against a breakup, everybody will have to do the same. Markets are beginning to reflect this.

The Bundesbank is also tightening credit at home. This would be the right policy if Germany was a freestanding country, but the eurozone's heavily indebted member countries badly need stronger demand from Germany to avoid recession. Without it, the eurozone's "fiscal compact," agreed last December, cannot possibly work. The heavily indebted countries will either fail to implement the necessary measures, or, if they do, they will fail to meet their targets, as collapsing growth drives down budget revenues. Either way, debt ratios will rise, and the competitiveness gap with Germany will widen.

Whether or not the euro endures, Europe faces a long period of economic stagnation or worse. Other countries have gone through similar experiences. Latin American countries suffered a lost decade after 1982, and Japan has been stagnating for a quarter-century; both have

survived. But the European Union is not a country, and it is unlikely to survive. The deflationary debt trap is threatening to destroy a still-incomplete political union.

The only way to escape the trap is to recognize that current policies are counterproductive and change course. I cannot propose a cut-and-dried plan, but three observations stand out. First, the rules governing the eurozone have failed and need to be radically revised. Defending a status quo that is unworkable only makes matters worse. Second, the current situation is highly anomalous, and some exceptional measures are needed to restore normalcy. Finally, the new rules must allow for financial markets' inherent instability.

To be realistic, the current fiscal compact governing the eurozone must be taken as the starting point. Of course, some already-visible defects will need to be modified. Notably, the compact should count commercial as well as financial debts, and government budgets should distinguish between investments that pay and current spending. In order to avoid cheating, what qualifies as investment should be subject to approval by a European authority. An enlarged European Investment Bank could then co-finance investments.

Most importantly, some extraordinary measures need to be invented to bring conditions back to normal. The EU's fiscal charter compels member states annually to reduce their public debt by one-twentieth of the amount by which it exceeds 60% of GDP. I propose that member states jointly reward good behavior by taking over that obligation.

The member states have transferred their seignorage rights to the ECB, and the ECB is currently earning about €25 billion ($32.7 billion) annually. The seignorage rights have been estimated by Willem Buiter of Citibank and Huw Pill of Goldman Sachs, working independently, to be worth between €2-3 trillion, because they will yield more as the economy grows and interest rates return to normal. A Special Purpose Vehicle (SPV) owning the rights could use the ECB to finance the cost of acquiring the bonds without violating Article 123 of the Lisbon Treaty.

Should a country violate the fiscal compact, it would wholly or partly forfeit its reward and be obliged to pay interest on the debt owned by the SPV. That would impose tough fiscal discipline, indeed.

By rewarding good behavior, the fiscal compact would no longer constitute a deflationary debt trap, and the outlook would radically improve. In addition, to narrow the competitiveness gap, all members should be able to refinance their existing debt at the same interest rate. But that would require greater fiscal integration, so it would have to be phased in gradually.

The Bundesbank will never accept these proposals, but the European authorities ought to take them seriously. The future of Europe is a political issue, and thus is beyond the Bundesbank's competence to decide.

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