An agenda for Europe's weary magicians
Jean Pisani-Ferry

Europe's leaders will meet again at the end of June. The question they must answer this time is not whether they can rescue this or that country, but whether they can rescue the eurozone – if not the European Union in its current form.

Illustration by Paul Lachine

To see why, just review the last 12 months. In July 2011, Europe's leaders agreed on a (limited) restructuring of Greek debt, while at the same time making financial assistance nimbler and cheaper. A year later, Greece remains on knife-edge.

Throughout last autumn, they agonized over the rise of Spanish and Italian bond rates, until finally the European Central Bank decided to administer pain relief in the form of large-scale liquidity provision to banks. But, despite the arrival of new, reform-minded governments in both Italy and Spain, the relief proved short-lived.

Then, last December, they agreed on a new fiscal treaty, a more robust financial firewall, and new resources for the International Monetary Fund, so that it could intervene on a larger scale. But, by early spring, bond rates for Spain and Italy were again approaching unsustainable levels.

Finally, earlier this month, they decided to devote €100 billion to help Spain clean up its ailing banks. The market's reaction was to send Spanish government bond rates even higher.

Contrary to some perceptions, Europeans have not remained inactive over the last year. But they have lost their touch. Like aging magicians, they still try tricks that used to impress, but that fail to deliver results – or, worse, prove counterproductive. Meanwhile financial fragmentation within the eurozone continues; Spain, and to a lesser extent Italy, suffers a seemingly irresistible rise in borrowing costs; and political strains grow more visible.

One summit will not result in decisions that take months to prepare. But Europe's leaders nonetheless have a chance to impress and start turning the tide, provided that they are sufficiently bold, comprehensive, and forward-looking. Here is a five-point agenda.

1. ***Accept a limited renegotiation of the Greek program*.** The bomb has not been defused. While Greece was having two rounds of elections, its recession deepened and policy action stalled. The EU-IMF program is off track, and more focus must be put on growth. The EU should streamline and front-load existing transfers to Greece, and it should help to trigger capital injection into state assets slated for privatization.

2. ***Agree on a risk-sharing scheme for Spanish banks.*** To lend more to Spain's government so that it can recapitalize the country's banks adds to its debt burden and scares markets, which fear future debt restructuring. To use the partner countries' taxpayers' money to rescue Spanish banks is neither economically justified nor politically acceptable. Instead, Spain should incur the first losses, and the eurozone's

financial-rescue fund, the European Stability Mechanism, should shoulder an increasing amount of the risk above a certain threshold (say, 5-10% of GDP).

3. ***Map a scheme for a banking union.*** A banking union – consisting of common deposit insurance, supervision, and crisis resolution – would help to avoid the mutual contamination of banks and sovereigns, which is why the idea was endorsed at the recent G-20 summit in Mexico. But it is an ambitious endeavor that cannot be launched overnight. If Europe's leaders want to show that they are seriously considering it, they should agree to launch concrete discussions on key parameters, giving their ministers a mandate to produce results by autumn.

4. ***Explore options for Eurobonds.*** Financial assistance can conceivably help Spain, but not Italy. If Italy's situation worsened, debt mutualization in one way or another would ultimately end up being the only alternative to large-scale default. But, while the European Commission has endorsed schemes for partial debt mutualization, there has never been a serious discussion about their conditions and implications. Europe's leaders cannot decide anything at this stage, but they should task a group of "wise men" (and women) to evaluate and report on options by summer's end.

5. ***Create conditions for macroeconomic adjustment.*** Southern Europe needs to deflate to restore competitiveness vis-à-vis northern Europe. Yet, in addition to being horribly painful, domestic deflation threatens the sustainability of public and private debt. With lower nominal income and the same level of debt, the threat of default necessarily increases. Northern Europe should temporarily accept somewhat higher inflation, provided price stability is maintained in the eurozone as a whole. Fortunately, German policymakers have indicated that they understand this logic. Leaders must now forge a consensus around it.

Most importantly, the leaders should break the political deadlock. Germany does not want closer financial solidarity if not accompanied by political integration. France wants financial solidarity without closer political integration. Both camps have stuck to their positions for at least a quarter-century.

It is time to bridge the gap between them. The perception that Europeans can agree on abstruse technicalities, but not on essentials, is a fundamental reason why the euro's magicians are losing their touch.

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