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Start by saving the eurozone

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Recession will test the single currency to breaking point unless measures are taken to counter the policies of the ECB

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The current global financial crisis has clearly underlined the need for more effective mechanisms of international cooperation. The stumbling initial response of the G7 risked prolonging the credit crunch. Today, while panic has eased somewhat in wealthy countries, the crisis is spilling into developing countries, with potentially devastating effects. Yet there is no coordinated effort to address the problems faced by emerging markets.

As Jeffrey Sachs argues, a Bretton Woods II may be necessary to build a new global financial and economic system. In fact, the multilateral, cooperative spirit of Bretton Woods is urgently needed today. If the crisis only deepens the divide between haves and have-nots, it is difficult to see how an international summit could be successful. And at the top of today's agenda must be saving the eurozone.

Last week's coordinated bank recapitalisations helped calm the panic in the wealthiest European countries, but there are signs that the problem has been stamped out in one place only to resurface in another. Most ominously, expectations are rising that some European governments will default on their debts. During the last three months, the implied risk that Ireland, Italy and Greece will default within five years - based on credit default swap spreads for their sovereign debt - has quadrupled from approximately 3% to 12% each.

So far, credit default swaps (CDSs) have correctly predicted the spread of risk from mortgage-backed securities, to consumer lenders and investment banks, then to commercial banks. Now they are pointing to some of the wealthiest sovereign nations.

This is only logical. In many European nations, banks have amassed more debt than taxpayers can afford to repay. These liabilities need to be refinanced periodically, but the current crisis has made that more difficult. In addition, bank debt was largely used to buy assets based on real property that is falling in value. In a severe recession, that decline could render much of the European financial sector insolvent.

This is all old news. However, by guaranteeing their systematically important financial institutions, European governments assumed that risk themselves. For example, the Irish announced they would guarantee all liabilities of their major banks - over 3 times current GDP and over 12 times government revenues. ING's assets equal 2.9 times Holland's GDP at €1.3tn; the recent recapitalisation provides €10bn of new capital, or just 0.8% of total assets. If asset values fall sharply, much more capital will be required. Can these countries afford to support all of their core financial institutions? This is the question markets are starting to focus on.

The 1997-98 emerging markets crisis showed how such conditions can lead to collapse. A country finds that its creditors are increasingly reluctant to hold its bonds due to perceived risk. Interest rates on that nation's debt rise, making the debt harder to pay off. To win back confidence, the country needs to tighten fiscal policy, but this can be politically difficult. Fear grows that, instead, the country will inflate its debt away or default outright; rates rise further. The prophecy is ultimately self-fulfilling: fear of a collapse leads to collapse.

The standard policy prescription is to tighten fiscal policy and let the exchange rate depreciate sharply. This raises exports, reduces imports and improves national savings.

The problem, however, is that eurozone nations no longer have control over their monetary policy, the European Central Bank (ECB) does, and its mandate is to maintain a 2% inflation target. Troubled countries, including Greece, Ireland, Spain, Italy and Portugal, will prefer loose monetary policies, but are sure to be opposed by the Germans (and French) who insist on the low inflation target. Threatened countries will be forced to tighten their belts using fiscal policy and brace for a deep recession. This will be politically painful.

If there is a sufficiently deep, global recession, the eurozone may not survive. Countries threatened by default will question the merits of the euro; they will suffer high interest rates, negating one of its expected benefits, and will see other nations as benefiting at their expense. Nationalist politicians will argue that they are better off setting policy at home, echoing Iceland's cry: "every country for itself." The costs of abandoning the euro would be very high, but it could happen, given domestic political instability and intransigence within the eurozone. If one nation breaks away, investors will wonder who is next, cutting off financing from other countries. Contracts in euros will need to be abrogated, causing untold dislocation. The damage will be enormous.

However, there is a good chance this scenario can be avoided, if some difficult decisions are taken now before markets demand them through higher interest rates. At the least, failure to act now will require more expensive measures to be taken deeper into the crisis.

First, policy makers must generate confidence that they understand and are dealing with these dangers. The ECB's insistence on high interest rates has damaged its credibility. Recent joint efforts by governments, along with the 0.5 percentage point interest rate cut, are steps in the right direction.

Second, there need to be mechanisms to ensure that investors who bet against national solvency will lose money. To date, those investors are doing extremely well. We need to discourage such bets and cut the potentially self-fulfilling cycles of higher interest rates that lead to insolvency.

We recommend the following steps for the eurozone:

1. Lower the ECB base rate now to 2% from the current 3.75%. The coming global recession will dramatically reduce inflation pressures, and a rate cut is needed to offset the recession. Lower rates will help recapitalize banks by making their lending more profitable, and will allow them to charge less to mortgage holders. The 2% inflation target should not be abandoned but should be subordinated to the need for financial stability (without which there will likely be deflation down the road).

2. Create a European Stability Fund with at least €2tn of credit lines guaranteed by all Eurozone member nations and potentially other European countries with large financial systems such as Switzerland, Sweden and the UK. This fund should provide alternative financing to member countries in case market rates on their government debt become too high. This will prevent a self-fulfilling cycle of rising interest rates. The fund should be large enough to have credibility; countries could access the fund automatically, but should then adopt a 5-year program for ensuring financial stability, subject to peer review within the Eurozone.

3. All eurozone nations should launch temporary fiscal expansions of at least 1% of GDP. These plans should be aimed at reducing the severity of the upcoming recession and assisting people at risk of default on mortgages or other financial instruments, thereby helping people in trouble and reducing default rates in the financial sector.

4. The EU and Switzerland should develop a financial regulatory framework that recognises that systemically important institutions may need to be bailed out by Europe as a whole. One goal should be to reduce extreme differences in national financial risk and leverage so that these problems are less likely to reoccur.

These measures will not resolve all of Europe's problems. The coming recession is likely to be severe, and its impact will vary greatly across the eurozone. Some domestic politicians will argue against having one currency for such a diverse area. However, it would be far more costly to abandon the euro now than to keep it. Ultimately, to make good on last week's promise to support all core financial institutions, the eurozone must also promise to support all of its member nations. Otherwise the eurozone may become fragmented and the benefits of the euro will be lost.

This article was written by Simon Johnson, Peter Boone and James Kwak.

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