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Can Europe Save Itself?

By Peter Boone and Simon Johnson April 29, 2010 6:00 am

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When Jean-Claude Trichet (head of the European Central Bank) and Dominique Strauss-Kahn (head of the International Monetary Fund) rushed to Berlin this week to meet Chancellor Angela Merkel and the German Parliament, the moment was eerily reminiscent of September 2008 — when then-Treasury Secretary Henry Paulson stormed up to the United States Congress, demanding $700 billion in relief for the largest American banks.

Remember the aftermath of that debacle? Despite the Treasury argument that this would be enough, much more money was eventually needed, and Mr. Paulson left office a few months later under a cloud.

The problem this time is bigger. It is not only about banks; it is about the essence of the euro zone, and the political survival of all the public figures responsible.

If Mr. Trichet and Mr. Strauss-Kahn were honest, they would admit to Ms. Merkel "we messed up — more than a decade ago, when we were governor of the Banque de France and French finance minister, respectively." These two founders of the European unity dream helped set rules for the euro zone that, by their nature, have caused small flaws to turn into great dangers.

The underlying problem is the rule for printing money. In the euro zone, any government can finance itself by issuing bonds directly (or indirectly) to commercial banks, and then having those banks "repo" them (i.e., borrow using these bonds as collateral) at the European Central Bank in return for fresh euros. The commercial banks make a profit because the European Central Bank charges them very little for those loans, while the governments get the money — and can thus finance larger budget deficits. The problem is that eventually that government has to pay back its debt or, more modestly, at least stabilize its public debt levels.

This same structure directly distorts the incentives of commercial banks. They have a backstop at the European Central Bank, which is the "lender of last resort." And the central bank and the European Union put a great deal of pressure on each nation to bail out commercial banks in trouble.

When a country joins the euro zone, its banks win access to a large amount of cheap financing, along with the expectation that they will be bailed out when they make mistakes. This, in turn, enables the banks to greatly expand their balance sheets, plowing into domestic real estate, overseas expansion or crazy junk products issued by Goldman Sachs. Just think of Ireland and Spain, where the banks took on huge loans that are now sinking the country.

Given that the euro zone provides easy access to cheap money, it is no wonder that many more nations want to join.

No wonder also that it blew up. Nations with profligate governments or weak financial systems had a bonanza. They essentially borrowed funds from the less profligate elsewhere in the euro zone, backed by the European Central Bank. The Germans were relatively austere; the periphery enjoyed the boom. But now we have moved past the boom, and someone in Greece, Portugal, Spain, Ireland and perhaps Italy has to repay something — or at least stop borrowing. So Mr. Trichet and Mr. Strauss-Kahn go, cap in hand, to ask Germany for further assistance.

Three possible scenarios could result.

First, the European Central Bank may be allowed to really let loose with "liquidity" — and somehow buy up all the bonds of troubled euro zone nations. But this is exactly the process that always and everywhere brings about high inflation. The Germans would fight hard against such a policy, although it would prevent default.

Second, officials might still hope that bond yields for weaker governments widen but then stabilize. This is bad news for troubled euro zone countries, but they manage to avoid default. The rest of the world grows by enough to pull up even the weaker southern members of the euro zone plus Ireland. Call this the trickle-down scenario — or just a miracle.

Most likely, the situation is about to turn much worse, and a third scenario unfolds. The nightmare for Europe is not at this point about Greece or Portugal. It is all about Italian and Spanish bond yields.

This week those yields are rising quickly from low levels, while German yields are falling — so this spread is widening sharply. The yields for Spain, for example, are rising because hitherto inattentive investors, who always thought these bonds were nearly as safe as cash, suddenly realize there are reasonable scenarios where those bonds could fall sharply in value or even possibly default.

Given that Spain has 20 percent unemployment, an uncompetitive exchange rate, a great deal of public debt and a reported government deficit of 11.2 percent (compared with headline numbers for Greece at 13.6 percent and Portugal at 9.4 percent), everyone now asks: Does a 5 percent yield on Spain's 10-year bonds justify the risk?

The market is increasingly taking the view that the answer is no, at least for now. So, we can anticipate that Spanish (and Italian) yields will keep rising. In turn, this causes other asset prices to fall in those nations, thus worsening their banking systems, and hence leading to credit contraction and capital flight. It is a dismal prognosis.

Then it gets worse.

As rates rise, traditional investors in euro zone bonds, which are pension funds and commercial banks, will refuse to buy more. There will be no buyers in the market, and governments will not be able to roll over debts. We saw the first glimpse of this on Tuesday, when both Spanish and Irish short-term-debt auctions virtually failed. Once this happens more broadly, the problem will be too big for even Mr. Trichet or Ms. Merkel to solve. The euro zone will be at risk of collapse.

If this awful but unfortunately plausible scenario comes about, there is a clear solution. (Unfortunately, it is also anathema to Mr. Trichet and Ms. Merkel, and thus unlikely to be discussed seriously until it is too late.) This solution is the standard package that comes to all emerging markets in crisis: a very sharp fall in the euro, restructuring of euro zone fiscal/monetary rules to make them compatible with financial stability, and major external liquidity support — not because Europe has an external payments problem, but because this is the only way to provide credible budget support that softens the blow of the needed austerity programs.

The liquidity support involved would be large: If we assume that roughly three years of sovereign debt repayments should be fully backed — and it takes that kind of commitment to break such negative sentiment — then approximately $1 trillion would be needed to backstop Greece, Portugal, Spain and Italy. It may be that more funds are eventually needed, but in any case, the amounts would be less than the total reserves of China. These amounts would also be reduced as the euro falls; it could be heading back to well under $1 per euro, which is where it stood a decade ago.

External financial support would make sense only if combined with key structural reforms, including an end to the repo window at the European Central Bank. As the former UBS strategist Al Breach recently argued, the European Central Bank could instead issue bonds to all nations that would then be used for monetary operations; every central bank needs a way to add or subtract liquidity from the financial system.

These bonds would need to be backed by a small "euro zone" tax, thus making the European Central Bank more like other central banks around the world. It would no longer accept bonds of "regional governments" in the union as collateral, and instead would buy and sell "euro zone" bonds. In exchange for the bonds issued to governments, it will get money; that money belongs to the governments that own the central bank and could be shared equally between them (the individual nations' governments can then, for example, use these proceeds to retire some of their existing government debt). These new euro zone bonds would also offer a way for governments to roll over some of their existing debts.

If the euro zone does need this package, it cannot be managed under a "business as usual" model. The funds would need to come from the G-20, and extremely tough decisions over fiscal and monetary policy need to be handled in a fair and reasonable manner. Someone needs to be in charge on behalf of Europe (would this be the European Commission, or Ms. Merkel and the German government?) and someone needs to represent the G-20.

By far the most natural G-20 partner to manage this process is — despite all its baggage — the International Monetary Fund, but there's a serious problem.

Mr. Strauss-Kahn, the current head of the I.M.F. (who overlapped briefly with one of us — Simon Johnson — at the fund), very much wants to become the next president of France. There is no way for the G-20 to provide financing with him in charge of the I.M.F.; he has an obvious and unavoidable conflict of interest, and no incentive to make the tough decisions today that are required to sort out the euro zone.

Mr. Strauss-Kahn should consider resigning, allowing a respected financial leader of a relatively independent country to take charge at the I.M.F. One potential choice would be Mark Carney, the current governor of the Bank of Canada. Or, if the G-20 agrees — finally — that it is time to phase out the leading role of the G-7 (which has not done well of late), Montek Ahluwalia of India would be an outstanding candidate.