# The euro’s salvation lies in a little less Europe; not more Europe

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| *Does Europe need a fiscal union to support its monetary union? This column argues that the cause of Europe’s problems is not public sector ill discipline but rather private sector ill discipline. In such a situation, it asks whether we should be trying to save a drowning man by putting him in a straightjacket.*  The European credit crisis is as political as it is complicated. This breeds solutions in search of the problem. One of these is the ubiquitous idea that the euro’s woes can only be settled by fiscal union; the more rigid the better and no room for backsliding. The broad popularity of this idea is based around its appeal to those who have a preference for whips and chains and includes both Europhiles and Europhobes.   * Europhiles see fiscal union as part of a wider project in which monetary union is merely part and not an end in itself.   Problems with monetary union, argue the Europhiles, are self-evidently the result of the project being unfinished. They are on a journey to get as far away as possible from the trauma of two devastating wars.   * Europhobes pray that fiscal union is a necessary condition for the survival of the euro, so the self-evident impossibility of fiscal union will accelerate the abandonment of the project.   The founding fathers worried about the moral hazards that could be created by a currency without a country. In 1997 they agreed on the ‘no bail out’ clause and the Stability and Growth Pact. Many of us feared then that these messy compromises were not credible to the financial markets and, without market discipline, the single currency would encourage fiscal largesse. The logic was faultless. Credit spreads stayed low. But Eurozone governments did not embark on a spending splurge. Eurozone debt as a percentage of GDP was 72% in the year of the euro’s birth, and it slipped to 66% in 2007 (the last year before the crisis). Declines were even more pronounced in those countries where long-term interest rates had fallen furthest – and hence where market discipline had slacked off the most – such as in Spain, where the public-debt-to-GDP ratio fell from 63% to 36%. Far less discipline was observed outside the zone, in the UK and elsewhere. Private debt was the problem The problem in the Eurozone was not indiscipline in the public sector – it was indiscipline in the private sector, which lent and borrowed at spreads to national interest rates. In Spain, non-government debt rose from 80% to 270% of GDP. In Germany where there was least impact on interest rates, German private-sector debt as a percentage of GDP hardly budged in comparison. The European credit crisis relates more to Hyman Minsky’s ‘Financial Instability Hypothesis’ than to the ‘it was the Greeks’ fault!’ school of thought of some politicians (see [Minsky 1992](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=161024)).  Excessive, debt-financed private consumption in one country relative to another will be reflected in, but is not caused by, national current-account positions. And just as in emerging-market crises of old, when there was a loss of confidence in the asset values underpinning private borrowing, there was a sudden stop of the private flows that were financing these current-account positions. The two big issues: Fire-fighting and long-term reform There are two big issues to be addressed:   * How to respond to the ensuing crisis, and; * What institutional changes do we need to make in order to reduce the likelihood of such a crisis or its wider impact happening again.   In this note, I will focus on the latter issue, but what I would say on the former is that the only sustainable way to deal with balance of payments problems is not the Opium War Approach favoured by some in US Congress, but to either move up the value-chain or reduce real wages relative to others. The choices of how to do that are not simply devaluing the exchange rate or slashing social programmes. A similar effect to an exchange-rate devaluation, for instance, may be achieved by a fiscal devaluation where labour taxes are cut, especially for low-paid workers, and this is funded by consumption taxes (see [de Moolj and Keen 2012](http://www.voxeu.org/index.php?q=node/7851) on this site).  But the question I want to focus on is that if the real problem was debt-financed private consumption – the unwinding of which would always have had severe economic repercussions whatever the exchange-rate arrangements (recall the Savings & Loans debacle in the US) – how would a fiscal compact help the situation? How would it not have made the crisis far worse?  In danger of oversimplification, where national asset bubbles arise, an international interest rate is procyclical.   * When house prices are rising at 20% a year in Dublin and 5% in Dortmund, an interest rate set for the average will encourage more borrowing in Dublin and less in Dortmund.   Rather than being a compression of unit labour costs and house prices, there is a widening.   * Pan-European policies that make it harder for a fiscal stimulus in depressed Dortmund and harder for bank regulators to curb lending in booming Dublin will only make matters worse.   The fiscal devaluation I spoke of earlier as part of a solution to the current difficulties is hampered by our existing attempts to converge fiscal policy by pan-EU limits on the level of VAT.   * What we need to underpin a single currency and interest rate is more space for countercyclical national fiscal and regulatory policy, not less.  National regulatory policies are possible Some say it would be impossible to have national regulatory policy in a single currency area. Of course this is done every day across the many countries that share the US dollar. Moreover, we all recall Mervyn King’s memorable refrain that banks are global in life, but national in death. As long as there is national-taxpayer responsibility for local lenders, there will need to be space for national regulators to exercise some discretion, within a single regulatory framework. This common framework can set out the grounds and instruments for this regulatory space.  Triggered by an above-average rise in house prices in Dublin, Irish regulators could require lower loan-to-value ratios and in Germany higher ratios may be acceptable. No matter where lenders and borrowers are headquartered, contracts that sought to get round those national requirements could be unenforceable across Europe, limiting avoidance and evasion. Even if they have not done so before, if we had a national fiscal policy without fiscal compact, what would stop countries abusing the single currency?  It is important that we pause for a moment to assess where we have reached in Europe before we keep on digging. Although borrowers and creditors each complain that the other has been bailed out, both have suffered memorable levels of pain and are nursing wounds not easily forgotten. Credit spreads have arisen from the fire and fiscal restructuring has gone on, without the value of euro currency being undermined.  Who would have predicted that throughout this whole crisis the euro would be and remains overvalued on a price-competitiveness basis? It seems that in terms of market discipline, in terms of separating out national credits that may default from an international currency that will not, we have got today much of what we wanted at the beginning. But it has been a hodgepodge and needs formalising. Formalising the hodgepodge There should be a fiscal conversation at the EU level and perhaps a converging framework, tax code, and instruments, but there should also be space for countercyclical fiscal policy. There should also be a facility to address the dislocation of sudden stops – a stabilisation fund for governments that can be accessed for a long enough time to deal with liquidity issues but a short enough time to avoid procrastination, perhaps 12 months. During this time, the cost of funds should rise to indicate that this is not a long-term solution. It would need to be sized to cover the rollover of debt of half of the Eurozone for over 12 months and some additional borrowing. That would make it around $2 trillion, or twice of what we currently have. And the central bank needs to be a lender of last resort for banks facing liquidity problems, with national governments taking over and where appropriate closing down in an orderly manner those with solvency problems.  Debt restructuring and even defaults should be countenanced. It is interesting that those countries recovering quickest from the recession are those where there have been extensive debt restructuring and write-offs. To better balance the forces between debtors and creditors, Eurozone countries could even default and then use the stabilisation fund to tide them over before a return to markets within 12 months.  But above all else, we need to appreciate that the way to help a drowning man is not to put him in a straightjacket. Few benefits of a single market and single currency are lost by preserving countercyclical space in national fiscal and regulatory policy. One of the reasons why we strive to avoid financial crashes is that their first casualties are considered and balanced policies. Many of the seeds of the next crisis are sowed in the rescues of the current. Today, we must reflect that the euro’s long-term strength and salvation lies with a little less Europe in fiscal and regulatory policy, not more. References de Moolj, Ruud and Michael Keen (2012), “[Fiscal devaluation as a cure for Eurozone ills – Could it work?](http://www.voxeu.org/index.php?q=node/7851)”, VoxEU.org, 6 April**.**  Minsky, Hyman (1992), “[The Financial Instability Hypothesis](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=161024)”, The Jerome Levy Economics Institute Working Paper No. 74, May. |

Top of Form

Bottom of Form

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