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Europe: Four steps to fiscal union

By Tony Barber

Problems etched on its face? Euro coin production in Rome in 2001. Now Italy is among member countries whose sovereign debt is under pressure

As the conflagration in debt markets spreads to Italy and Spain, two of the world's 12 biggest economies, the question of the hour is whether Germany and other eurozone nations will decide to go further down the road of economic and fiscal union in order to extinguish the blaze once and for all.

A sovereign debt crisis that erupted in late 2009, with the discovery that Greece had misrepresented the condition of its public finances, has obliged the 17-nation eurozone since May 2010 to put together a battery of fire-fighting instruments. These go well beyond anything envisaged when the currency was launched in 1999.

The US, China and other powers are anxiously awaiting still more concerted measures so that Europe's troubles do not spread more turmoil through the global economy and financial system.

The bloc's more fiscally prudent members – above all Germany, Europe's largest economy – have endorsed multibillion-euro financial rescues for Greece, Ireland and Portugal, eased the terms of these rescues after they appeared too onerous, and secured a change to the European Union's basic treaty in order to establish a permanent crisis-fighting fund.

Now, as Europe enters what may prove to be the endgame for the euro – closer

eurozone integration or the disintegration of monetary union – a heavy burden of responsibility lies on national leaders and in particular Angela Merkel, German chancellor.

In the view of many non-European policymakers, not to mention some in Europe itself, Ms Merkel has played her hand cautiously, perhaps too cautiously, since the crisis broke out. But that is an approach for which she has long been known. Her old friend Reinhold Messner, a renowned mountaineer who met a holidaying Ms Merkel in Italy's South Tyrol region last week, says wrily: "She is a good hiker, because she goes slowly but keeps moving continuously forwards."

It is an appropriate image. Yet the biggest decisions about the survival of Europe's 12-year-old monetary union could be yet to come – and may need to be taken rapidly. What follows is an assessment of the measures in use at present and of the more far-reaching actions that may be judged necessary in the future.

European Central Bank: lender of last resort?

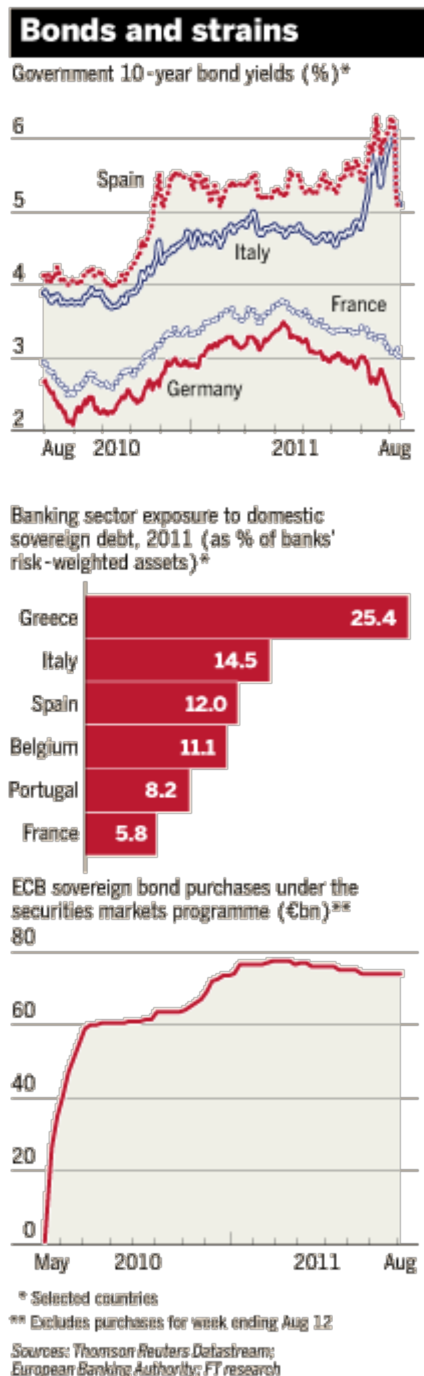
From its Frankfurt base, the European Central Bank is leading from the front in seeking to stabilise Europe's public and private financial sectors. In May 2010 it started a programme of bond-buying that has left it with about €74bn ($105bn) in Greek, Irish and Portuguese sovereign debt on its balance sheet. On Monday, it crossed the Rubicon and took the dramatic step of buying Italian and Spanish government debt.

This latest decision divided the ECB's 23-strong governing council, with up to four members – including Jens Weidmann, the Bundesbank's president and a former economic adviser to Ms Merkel – arguing against it. But it is doubtful that even those in favour intended to buy Italian and Spanish debt indefinitely. Until last week, the ECB had stayed out of the bond market for almost five months. For many ECB policymakers, the bond purchases risk blurring the distinction between monetary policy and fiscal policy on which the central bank's credibility as an inflation-fighter depends.

What opened the door to the bond purchases was the promise of accelerated austerity measures and growth-enhancing economic reforms from the governments in Rome and Madrid. "No reforms, no bond purchases" was the ECB's firm message. It was not too different from the line the ECB, European Commission and International Monetary Fund had taken towards Greece, Ireland and Portugal when they applied for aid.

Despite the IMF's important role in the support programmes for these three countries, it is possible to detect the faint outlines of a European economic government in the way that the EU authorities have handled the upheavals in the eurozone periphery. In

essence, central European institutions – implicitly backed by Germany's financial firepower – are assisting vulnerable countries and are demanding in return the right to shape their economic policies.



A different concern for the ECB is that, by June, it had €418bn in loans outstanding to eurozone banks. Greek, Irish, Portuguese and Spanish banks accounted for almost two-thirds of this sum. However, much of it was secured against collateral of dubious quality. Even two months ago the risk was growing that the ECB might have to turn to European governments to recapitalise itself. Under such circumstances the ECB might find it hard to preserve the legally enshrined independence from political pressure that it cherishes so much. A foundation stone of Europe's monetary union would be under threat.

The trouble is that, having started to buy Italian and Spanish debt, the ECB may find it difficult to stop without puncturing market sentiment. "Investors' enthusiasm can fade quickly unless there is a constant buying flow," says Luca Cazzulani at Unicredit. "Investors will want to see amounts of purchases which are commensurate with the size of the Italian and Spanish market."

The ECB would clearly like to transfer responsibility for bond purchases to the European financial stability facility, which is the chief emergency lending instrument of eurozone governments. In the meantime, however, the ECB may end up acquiring tens of billions of euros of Italian and Spanish debt. A recapitalisation of the ECB is starting to look inevitable. The battle to preserve the principle of central bank independence will then be joined.

European stability mechanism: the long-term answer?

Eurozone governments agreed on July 21 to let the EFSF acquire sovereign debt at a discount on the secondary market; to finance the recapitalisation of banks; and to extend pre-emptive credit lines to countries under pressure in debt markets. All this seemed rather bold at the time. But only three weeks later, there is pressure on governments to authorise an even bigger expansion of the EFSF's size and role.

So far, Germany and its fiscally hawkish allies – Finland, the Netherlands and others – are putting their feet down and saying no.

The EFSF's effective lending power stands today at €255bn. Assuming that national parliaments approve the decisions taken at the July 21 summit – not in itself a smooth process, given political resistance in smaller countries such as Slovakia – it will rise by October to €440bn. But even this sum would be insufficient to launch financial rescues for Italy and Spain, eurozone policymakers accept. Upward pressure on Italian and Spanish bond yields may therefore persist. To halt it, the EFSF may need to be equipped with firepower amounting to €1,500bn or even more, economists say.

The problem is that the EFSF is a private company that issues debt to raise the funds needed to extend loans to struggling eurozone countries. To benefit from the lowest interest rates, its bonds require a triple A rating. This in turn depends on the core eurozone countries – above all, Germany and France – maintaining their own triple A status.

But if the EFSF's lending capacity were expanded to enable it to cover Italy and Spain, France's total contingent liabilities would rise to €245bn, or 12.7 per cent of gross domestic product. This might cause France, like the US last week, to lose its triple A rating. The pressure on Germany, as the EFSF's financial backstop of last resort, would grow accordingly. This might unleash resentment and anger among German politicians and voters, who were promised by their leaders in the 1990s that the sacrifice of the D-Mark would never mean having to dig other countries out of financial holes.

If the eurozone survives the next two years, the EFSF will be replaced in July 2013 by a permanent European stability mechanism. The current crisis may force changes. But as presently designed, the ESM will have a lending capacity of €500bn and a total subscribed capital of €700bn, of which €80bn will be paid up and €620bn in callable capital and guarantees. Because this structure involves a firm, up-front commitment of funds, it ought to give the ESM a more secure triple A rating than the EFSF.

Eurozone-wide bonds: nectar or poison?

some politicians say the most convincing message that could be sent to markets about their determination to stand by the euro would be the introduction of common eurozone bonds. Jean-Claude Juncker, Luxembourg's prime minister, who chairs meetings of eurozone finance ministers, and Giulio Tremonti, Italy's finance minister, proposed in the Financial Times last December to set up a European Debt Agency that would replace the EFSF and issue "e-bonds".

Germany and other countries with a record of strict fiscal prudence oppose e-bonds, describing them as a form of "sweet poison" or fatal temptation. According to

politicians the Christian Democratic party, the senior partner in Germany's ruling coalition, e-bonds would enable less disciplined nations to piggyback on the strong German credit rating and would impose higher interest rates on the country's debt.

Still, the times may be changing. Although there is no sign that Berlin is relaxing its opposition, support for e-bonds is growing in the Social Democrat and Green opposition parties.

Moreover, if the ECB and EFSF were to buy Italian and Spanish bonds in huge quantities, and if the ECB were massively recapitalised by eurozone governments, this would amount to a financial transfer from Germany and its allies to the rest of the eurozone in any case. Conceivably, Germany might eventually view a common eurozone bond as a prefer able way of stabilising sovereign debt markets.

Germany's worries about higher interest rates have been addressed in an imaginative way by a pair of economists named Jacques Delpla and Jakob von Weizsäcker. In May 2010 they published a path-breaking paper for the Bruegel institute, a Brussels-based think-tank, that proposed the introduction of two types of eurozone debt instrument – "blue bonds" and "red bonds".

Blue bonds would be jointly guaranteed by eurozone governments and would cover up to 60 per cent of GDP – the ceiling for public debt under EU fiscal rules. These would be super-safe, blue-chip bonds, enjoying pride of place in any investment portfolio.

However, if a government wished to issue bonds above the 60 per cent threshold, these would count as "red" debt. As a purely national responsibility, not guaranteed by other eurozone governments, the red bonds would naturally attract higher interest rates. In theory, these arrangements would provide a strong incentive for governments to cut their debt to below 60 per cent.

Economic governance: the dog that does not bark?

New-look monetary union is to be rounded off with a set of strengthened rules on economic governance, covering areas such as budget deficits, public debt and competitiveness. The crucial element is the increased use of what in Brussels-speak is known as "reversed qualified majority voting" for warnings and sanctions if a government breaks the rules. Fines would become semi-automatic because governments would have to muster a majority to reject a sanctions proposal from the European Commission, the EU's executive arm, rather than to approve it.

Whether any government will really be punished is another matter. No fines were ever imposed under the EU's old stability and growth pact. If governments took more radical steps towards a true fiscal union, however, matters might be different.

Jean-Claude Trichet, the ECB president, sketched out a proposal in June for a

European finance ministry – not to administer a large federal budget but to supervise national fiscal and competitiveness policies. Such an entity could be empowered to levy fines. In similar fashion, Philipp Rösler, Germany's economy minister, suggested this week that the eurozone should set up a "stability council" to enforce the area's fiscal and competitiveness rules.

Some eurozone finance ministers are sympathetic to such ideas. "We need more and better integration. We have the ECB but we don't have real integration on the budgetary side," says Didier Reynders, Belgium's finance minister. "We need more capacity to take budgetary measures at eurozone level."

At almost every stage of the debt crisis, the force of events has pushed the eurozone towards more integration. This has had the effect of marginalising the influence of EU countries that do not use the euro, notably the UK – in spite of the deep involvement of its financial sector in the crisis. But it also underscores a more disturbing point that seems certain to stir controversy if the trend towards closer economic union continues. That is the lack of democratic consultation with European citizens about the direction the eurozone is taking.

Waltraud Schelkle, an expert on European integration at the London School of Economics, describes the lack of democracy as "the elephant in the room". On the one hand, George Papandreou, Greek prime minister, is told by his eurozone peers to push austerity programmes devised in Brussels through an Athens parliament that has had no say in framing them. On the other hand, Ms Merkel has to tell her CDU backbenchers to support costly rescue programmes that she had previously promised would not materialise, and over which they have had next to no influence.

For the past 18 months, eurozone policymakers have been so busy trying to put out fires that they appear to have given little thought to the democratic deficit. However, as Ms Schelkle warns: "In the end, the elephant in the room may squash, if not crush, the euro."

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