The Eurozone Troubles

The European Union and its common currency will hold together, but the road to recovery will be long.

The eurozone's troubles no longer qualify as a crisis, an unstable situation that could either quickly improve or take a dramatic turn for the worse. They are, instead, a new normal - a painful - situation, but one that will last for years to come. Citizens, investors and policymakers should let go of the idea that there is some magic bullet that could quickly kill off Europe's ailments. By the same token, despite the real possibility of Greek exit, the eurozone is not on the brink of collapse. It has been nearly two and a half years since the incoming Socialist government in Greece revealed the extent to which its predecessor had accumulated debt, precipitating an economic storm that has left slashed budgets, collapsed governments and record unemployment in its wake. With each dramatic turn, observers have anticipated the story's denouement. But again and again, a definitive resolution - either a policy fix or a total collapse - has failed to emerge.

The truth is that there are no quick escapes from the eurozone's predicament. Divorce is no solution. Although some economists suggest that struggling countries on the periphery could leave the euro and return to a national currency in order to regain competitiveness and restore growth, no country would willingly leave the eurozone; doing so would amount to economic suicide. Its financial system would collapse, and ensuing bank runs and riots would make today's social unrest seem quaint by comparison. What is more, even after a partial default, the country's government and financial firms would still be burdened by debt denominated largely in euros. As the value of the new national currency plummeted, the debt would become unbearable, and the government, now outside the club, would not be able to turn to the eurozone for help.

Some economists go further and argue that countries on Europe's periphery could thrive outside the euro straitjacket. This is equally unconvincing. Southern European countries' economies suffer from deep structural problems that predate the euro. Spanish unemployment rates fluctuated between 15 and 22 percent throughout most of the 1990s; **Greece has been in default for nearly half of its history as an independent State.** These countries are far more likely to tackle their underlying problems and thrive inside the eurozone than outside it. Others have suggested that Germany and other core countries - weary of funding endless bailouts - might abandon the euro. That is even less plausible. Germany has been the greatest beneficiary of European integration and the common currency. Forty percent of German exports go to eurozone countries, and the common currency has reduced transaction costs and boosted German growth. An unraveling of the eurozone would devastate German banks, and any new German currency would appreciate rapidly, damaging the country's export-led economic model.

A number of policy reforms may improve economic conditions in the eurozone, but none offers a panacea. Eurobonds, increased investment in struggling economies through the European Investment Bank and other funds, stricter regulations of banks, a common deposit insurance system, a shift from budget cuts to structural reforms that enhances productivity and encourages private-sector job creation - all of these could improve Europe's economic situation and should be implemented. But none of these measures would quickly restore growth or bring employment back to pre-crisis levels. That is because they do not address Europe's central economic problem: the massive debt accumulated by the periphery countries during last decade's credit boom. The 2000s saw a tremendous amount of capital flow from the Northern European countries to private and public-sector borrowers in Greece, Ireland, Portugal and Spain. Germany and other countries with current account surpluses flooded the periphery, with easy credit, and the periphery gobbled it up. This boosted domestic demand and generated growth in the periphery but also encouraged wage inflation that undermined competitiveness and left massive debt behind. As the economists Carmen Reinhart and Kenneth Rogoff have pointed out, when countries suffer a recession caused by a financial crisis and debt overhang, they take many years to recover. With both breakup and immediate solutions off the table, then, the eurozone is settling into a new normal. As the Union slowly digs itself out of the economic pit, it is important to recognize that its system of economic governance has already been fundamentally transformed over the past two years.

In any monetary union in which States retain the autonomy to tax, spend, and borrow, there is a risk that some countries' excessive borrowing could threaten the value of the common currency. Recognizing this, the euro's creators drafted the Stability and Growth Pact (SGP) and the "*no-bailout*" clause in the Maastricht Treaty. The SGP placed legal restrictions on Member-State deficit and debt levels, and the no-bailout clause forbade the European Union or individual Member States from bailing out over-indebted States to avoid moral hazard. The Maastricht governance regime is dead. The SGP was never strictly enforced, and when the crisis hit, the European Union tossed aside the no-bailout clause. Fearing contagion, it extended emergency loans to Greece, Ireland and Portugal and set up a permanent bailout fund - the European Stability Mechanism (ESM) which will be up and running this summer. **Having broken the taboo on bailouts, Europe had to find a way to limit the moral hazard of States turning again and again to the European Union for aid.** EU lawmakers introduced the so-called "six-pack legislation", which strengthened the European Commission's ability to monitor Member States' fiscal policies and enforce debt limits. Twenty-five EU Member States signed a fiscal compact treaty, which committed them to enshrining deficit limits into national law. Only those States that eventually ratify the treaty will be eligible for loans from the ESM. Such legal provisions alone will not overcome the moral risk, but they have been accompanied by evolution in bond markets, which now distinguish between the debt of healthy governments in the core and weak ones on the periphery. **For the first decade of the euro's young life, bond markets priced the risk associated with the peripheral economies' bonds nearly the same as that associated with German ones.** Today, the yield spreads are substantial and increase at the first sign of heightened risk. And by forcing private investors to take a nearly 75 percent loss on Greek bonds in conjunction with the second Greek bailout in February 2012, European leaders made clear that private bondholders should not expect bailouts to cover their losses, too. Now, more vigilant bond markets will police governments that run up unsustainable deficits or whose banking sectors grow fragile.

The second major structural change is that the European Central Bank legally prohibited from purchasing any Member State's debt has thrown its rules aside and directly purchased billions in Greek, Irish, Italian, Portuguese, and Spanish bonds. Moreover, the ECB has indirectly financed billions more loans through its long-term refinancing operation, which extended over a trillion euros in low-interest loans to commercial banks. ECB President Mario Draghi has repeatedly insisted that the bank is not engaging in "*monetary financing*" of Member-State debts. In practice, the ECB has shown itself to be far more flexible than many had anticipated. It has revealed, quite simply, that it will not oversee the demise of the currency that justifies its existence. This new system of eurozone governance is more sustainable than the pre-crisis regime set in place by the Maastricht Treaty. It will survive a Greek exit, for example. **If Greece refuses to adhere to the terms of its bailout package and is forced out of the eurozone in the coming weeks, the ECB will likely scramble to stop contagion, but it will not be faced with the entire system's collapse.** Meanwhile, by standing firm on Greece, the European Union will have further demonstrated that the conditions attached to its bailouts are serious, motivating other States to stick to their reform programs. Greece's exit from the eurozone would be a catastrophe for Greece and a trauma for Europe, but it would not change the fundamentals of the post-2008 eurozone governance regime, which will still be based on stronger fiscal surveillance, more robust enforcement procedures, more vigilant bond markets, and a more activist Central Bank. With such a system in place, and with their commitment to fiscal discipline established, EU leaders will now face the slow, difficult tasks of adjustment and structural reform. And those burdens must be shared by all. It is understandable that Germany and the ECB initially demanded austerity as the condition for bailouts, but this one-sided approach has driven peripheral economies deeper into recession. Moving forward, austerity, wage reductions, and structural reform on the periphery must be coupled with public spending and wage increases in Germany, which will boost demand. There will be no quick fix, but the eurozone will recover, slowly but surely.