Can Europe Get its Political Act Together?

Alternative Scenarios for the Euro Area

By William R White[1]

Introduction

It is tempting to focus on the special character of the European Union and the euro area, and to conclude that the economic and financial crisis faced by Europe has arisen uniquely from these characteristics. This is not true. In fact, Europe's crisis is just a microcosm of the global economic and financial crisis which has affected all the advanced market economies (AMEs) and most of the emerging market economies (EMEs) as well. Similarly, within the Euro area, the problems of Cyprus can be viewed as a microcosm of the broader problems facing Europe.

This insight also helps explain why seemingly small events, like banking failures in Greece and Cyprus, must be taken seriously and carefully handled. It is because they threaten to resonate on a larger scale and trigger similar exposures elsewhere with more profound effects and costs. Unfortunately, this insight also implies that solutions to problems in the Euro area, while highly desirable in themselves, will be no global panacea. Elsewhere - in China, the United States, in Japan and the BRICs - other serious problems remain, and they also have the capacity to resonate on a grander scale. The extent to which globalization has been extended in recent decades, in both the real and financial sectors, implies that when "the bell tolls" it now tolls for everyone.

The roots of the continuing global crisis lie in the buildup of unsustainable debts, both public and private, over many decades in the AMEs. As with many previous crises historically, this buildup occurred against the background of many encouraging developments in the real economy. In particular, the reentry of many "command and control" economies into the global trading system in the early 1990's led to significant disinflationary pressures almost everywhere. A fiat money system then allowed leveraged credit creation and a lowering of credit standards. This eventually became excessive but was not adequately resisted by either supervisors or central banks. In particular, the asymmetric policies of central banks – never raising rates in upswings as much as they lowered them in downswings – implied a series of consecutive

[1] The author is writing solely in his personal capacity. His views are not necessarily endorsed by any organization to which he is currently or has previously been associated.

"bubbles" in which each had its roots in the bubble before. This led in turn to the cumulative growth of a variety of imbalances in the real economy, not least overbuilding in the housing sector, and a degree of financial over extension that has left both borrowers (households and many sovereigns) and lenders (banks and "shadow banks") dangerously exposed to any potential future shocks. It is a simple fact that if debtors do not pay, creditors do not get paid. And, of course, if the health of the financial system is threatened in consequence, this can lead to a tightening of credit standards which then slows the real economy even more.

The credit expansion in the AME's should have led to a general reduction in the value of their currencies, and an associated increase in domestic inflationary pressures. However, absent any form of discipline from the International Monetary System, this was sharply resisted by EME's. For reasons both legitimate and illegitimate, they turned instead to massive foreign exchange intervention as well as easier domestic monetary policies. This unleashed a global tide of liquidity that encouraged still more debt accumulation. Some of this effect was seen in the AME's, where debt levels are now significantly higher than they were at the beginning of the crisis. However, much of the damage was reserved for the EME's themselves. Falling rates of growth of productivity in EMEs, after earlier increases, now threaten inflation and many EME's now exhibit many of the imbalances that earlier characterized the AME's.

This global story also played out in the Euro area, though evidently with many twists to the story arising from Europe's economic and political peculiarities. Nevertheless, the two central elements of the European story were the same; excessive credit expansion, and the role of exchange rate arrangements in amplifying its bad effects. Both at the global level and in the context of Europe, these developments have fostered debate about institutional features of our economies, and whether major structural reforms are now required. It is concluded below that such reforms are required in Europe, and I have argued elsewhere[2] that we urgently need to revisit our current International Monetary (Non) System as well.

The Dynamics of the Euro Area Crisis to Date

To some degree, the Euro area project had its roots in the failure of the International Monetary System. After the breakdown of the Bretton Woods System, periods of dollar weakness were accompanied by enormous exchange rate tensions within the European area. When more limited efforts, like the "snake in the tunnel" and the European Monetary System failed to cope with these pressures, a group of central bank governors were mandated to meet and to search for "technical" solutions. The creation of the Euro area and the European Central

[2] William White "A role for international policy coordination?" Panel remarks at a Conference on "International macroeconomic policy cooperation: Challenges and prospects" Bank of Canada, 13-15 November 2013.

Bank gradually emerged from these discussions. It was anticipated from the beginning that capital within the Euro area would flow from high saving countries (largely at the centre) to fuel increases in productivity in low saving countries (largely in the periphery) and that this would encourage a broader process of convergence of both industrial and other practices as well as living standards in the euro area. Unfortunately, this process began to go wrong even before the euro was formally introduced.

At heart, the euro crisis reflects a massive market failure based on the mistaken belief that there could be no balance of payments problems within a currency union. Its first manifestation was in 1997 as sovereign interest rates within the euro area began to converge on German rates in spite of wide differences in objective circumstances. One aspect of this, though not the most important, was that neither the market, nor the rating agencies, nor the ECB paid adequate (indeed any) attention to different levels of sovereign debt across countries in the euro area. This initially benefitted Belgium and Italy, which had relatively high levels of sovereign debt, but also some of the peripheral states that joined later. Subsequently, and much more importantly, private sector capital flows from the centre to the periphery expanded enormously, with interbank lending playing a crucial role. As a result, interest rates and credit terms continued to converge across the euro area until 2001, and credit spreads remained very small until the crisis erupted in 2008.

What the lenders failed to evaluate properly, and for which they must accept blame, was the use to which their funds were being put. Far from supporting a process of convergence through sound investments and higher productivity, the capital inflows to peripheral countries rather supported a variety of excesses. In Ireland and Spain, the most obvious manifestation was a massive housing boom, rising wage costs and growing trade deficits. In Italy and Portugal, much needed structural reforms were put off as easy access to foreign credit financed ever growing trade deficits and declining competitiveness. In Greece, Slovenia and Cyprus a lethal combination of all of the above problems eventually emerged. Had the member states not been in a currency union, exchange rate crises would have moderated all these processes. However, absent the possibility of such periodic adjustments, the imbalances just noted were able to cumulate and eventually led to the much more serious crisis the Euro area still faces.

While the Euro area crisis has often been classified as a “sovereign debt crisis”, this is not correct. Similar to the development of the global crisis, the Euro area crisis first emerged in the financial sector with the collapse of the interbank market after the failure of Lehman Brothers. Only later, as the global recession deepened, did the crisis spread to affect sovereign bond rates in the peripheral countries. Indeed, prior to the crisis, some peripheral countries actually had sovereign debt levels that seemed significantly more manageable than those of

Germany and France. Paul De Grauwe and Yeumi Ji have even suggested[3] that some of the peripheral countries would never have had a problem of unsustainable sovereign debt had "market panic", prompted by an unwarranted focus on sovereign debt, not led to a "bad market equilibrium".

It was only when the global recession took hold in 2009 that fiscal deficits exploded everywhere. Tax revenues related to the preceding "boom" were revealed as unsustainable, automatic stabilizers kicked in, and some governments engaged in discretionary fiscal expansion. Carmen Reinhart and Kenneth Rogoff remind us[4] that the transformation of private sector debt to public sector debt during crises has been a common historical occurrence. Worse, many peripheral sovereigns eventually found themselves cut off from market funding or facing extremely high borrowing costs. As a result, they had to turn to the Troika (ECB, EC and the IMF) for financial support and, of course, accept the conditionality that came with it.

Rather than being a "sovereign debt crisis", the Euro area problem would be more accurately described as a "balance of payments crisis". It began with a "sudden stop" in the private sector funding previously available to peripheral borrowers, particularly banks. Banks in peripheral countries had experienced a massive increase in their balance sheets, and lenders suddenly began to harbor fears about their possible insolvency. Absent continued external financing for large current account deficits, domestic spending (absorption) had to fall massively to reduce imports to the level that the private sector was willing to finance. This was the basis of the extraordinarily steep recessions that followed.

The capital exodus was made worse by four other considerations. The first is the so called "bank- sovereign nexus". Troubled banks can traditionally turn to their sovereigns for support. Similarly, troubled sovereigns could borrow from their domestic banks. However, the rapidly increasing debts of the peripheral sovereigns eventually began to raise doubts about their capacity to support their banks. At the same time, the purchases of doubtful sovereign debt by domestic banks was increasingly seen as a threat to the bank's own solvency. In effect, what had been the hope of mutual support turned into fears of mutual insolvency. Second, creditors who had previously entertained few doubts about their own solvency increasingly began to have such worries. This implied a general tightening of credit conditions, even in creditor countries, but eventually an effective collapse of cross border lending. As is also typical, lenders overreact in both the boom and bust phases of a financial cycle.

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[3] Paul De Grauwe and Yeumi Ji "Panic driven austerity in the Eurozone and its implications" Vox, 21 February, 2013.

[4] Carmen M Reinhart and Kenneth S Rogoff (2009) "This time is different: Eight centuries of financial folly" Princeton University Press, Princeton

A third concern, and the “elephant in the room”, was that domestic depositors in peripheral countries would begin to withdraw deposits from domestic banks, given the absence of euro denominated deposit insurance. This phenomenon was clearly seen in Ireland, Greece and, for a time, in Spain. Finally, capital repatriation seems to have been actively encouraged by domestic regulators in creditor countries. While this might have seemed prudent and sensible from a purely domestic viewpoint, from the systemic perspective of the Euro area as a whole, it made little sense. Of course, regulators and central banks working at cross purposes is hardly a new phenomenon.

The upshot of this is that the Euro area faces a continuing perhaps existential crisis. Greece, and potentially other small peripheral sovereigns, might have debt levels that are unsustainable. Unfortunately, they have a competitiveness problem as well, implying that domestic deflation to address external trade issues only exacerbates the real burden of debt service. While the systemic importance of the failure of a small sovereign, and/or its banking system, might be debatable, there seems little doubt that similar problems in Spain or Italy would have serious market consequences for others in the euro area. For a starter, it would constitute a further threat to the solvency of major banks in the core creditor countries, many of which are already suffering from significant funding problems. Beyond this, it would undermine confidence in the Euro area project as a whole. Given the complexity of the interconnectedness, between creditors and debtors and between sovereigns and banking systems, highly non linear outcomes would not be unexpected.

The worst prospect for creditors would be the departure from the Euro area of one of the peripheral countries. This might arise due to an unexpected and sudden shortage of euro liquidity, the inability of governments to pay their bills, leading to the forced introduction of a new currency to allow the state to continue functioning. Another possibility would arise from member states weighing out the costs and benefits of staying versus leaving and eventually opting for the latter. Evidently, a forced departure would be more disruptive than a managed one.

For peripheral countries, leaving the Euro area would have many effects. On the one hand, it would allow the introduction of a domestic currency, likely subject to a sharp depreciation in its value, increased competitiveness and more rapid growth. On the other hand, the increased competitiveness might easily be offset by higher inflation. Moreover, external debts denominated in euros would become even harder to service and repudiation would become much more likely. Finally, there is the complication that leaving the Euro area is technically “illegal” and would lead to expulsion from the European Union. In contrast, staying in the Euro area would demand receiving external liquidity support from the Troika and all the conditionality likely to be attached to it. For core countries the effects of a break up would likely be reversed. Their currencies would appreciate, perhaps threatening outright deflation, and many of their presumed assets would not in fact be serviced as debtors defaulted.

Up until now, all the members of the Euro area have judged it in their respective individual interests to keep the zone together. The collective vision of a more united Europe has undoubtedly played a major role as well. Creditor countries have continued to provide liquidity, while debtor countries have embarked upon adjustment programs of fiscal austerity and structural reform. Nevertheless, in spite of the relative calm prevailing through to the spring of 2014, these efforts have not fully reestablished market confidence. One reason, to be treated in the next few sections, is that the market retains doubts about the effectiveness and sustainability of a number of the policy responses to date. Perhaps even more important, many economic and political challenges will need to be overcome if the Euro area is to be put on a more sustainable footing going forward.

Implementing Effective Policy Solutions: The Should, Could and Would Problems

Actually implementing effective policy solutions to practical problems has never been easy. As has been known from classical times, three sets of difficulties must first be recognized and then overcome. I refer to them as the "should, could and would" problems. They might also be referred to more narrowly, with reference to the Euro area having an "analytical deficit, an executive deficit and a democratic deficit". I prefer the broader classification.

The "should" problem refers to getting agreement at the level of theory about what needs to be done. In the context of euro area issues, this is largely though not exclusively the realm of **economics**. The "could" problem refers to the issue of power and whether agents that need to act have the powers required to do what they should do. This is largely the realm of the **law and regulation**. Finally, there is the "would" problem. Even if the proper policies have been identified, and could be carried out, is there a sufficient willingness to act in order to do what needs to be done? This is largely the realm of **politics.** Moreover, when discussing euro area issues, it is not just national politics but international politics as well.

Finally, to add to the difficulty of implementing effective policies, there is also a logical hierarchy here that must be respected. Solving the "would" problem requires a prior solution for the "could" problem, which in turn requires prior agreement on the "should" problem. Evidently things could go wrong at any level and, according to Murphy's Law, might very well do so.

One important source of “should” problems in the euro area is that creditor governments seem to have strongly held economic beliefs. While other governments consider these beliefs wrong at worst, and disputable at best, the beliefs of the creditors have thus far prevailed. Perhaps it is not surprising that such big differences of views exist between creditors and debtors. Indeed, similar differences were evident in the discussions leading up the agreements reached at Bretton Woods, and again the views of the creditors prevailed.

Most importantly, core country governments emphasize that the problems in the euro area have their roots in an excessive build up of sovereign debt rather than being creditor induced balance of payments problems having their roots in private sector excesses. Creditor governments thus feel that sovereign debtors are responsible for their own problems and should bear the full burden of adjustment. Put otherwise, cross border burden sharing is not to be part of the adjustment exercise. Creditors have recognized the need for liquidity support in some cases, but this has led to the conclusion that financial support comes in the form of loans and more debt. As well, the burden of debt service has been generally assumed to be manageable provided debtor countries follow appropriately austere policies. Conveniently, creditor governments also tend to believe that fiscal multipliers and the cost of domestic austerity on the part of debtors are likely to be small and also politically manageable. As well, there seems scant recognition of the arithmetic that, if peripheral country trade deficits are to fall, the surpluses of other countries must fall as well.

When it comes to beliefs about central banks, creditor countries at the core of the euro area believe that central banks should focus solely on price stability and should limit their concerns for financial stability to well collateralized lender of last resort functions. While central banks can provide limited and temporary support to banks, they must eschew providing any support to governments that looks like the financing of government deficits. Central Europeans also tend to believe that inflation is likely to be a more serious policy problem than deflation. They thus tend to react badly to the suggestion that undesirably low inflation (or even deflation) in peripheral countries should be offset (subject to the ECB’s inflation target) by an undesirably high inflation level in the core.

Without saying any or all of these views are wrong, they can at least be disputed and increasingly are being disputed. However, it is also a fact that these beliefs tend to be firmly held, not just by some governments in central Europe, but also by the voting public. Moreover, some of these views are already hard wired into European institutions like the European

Central Bank. In sum, getting agreement on what “should” be done to restore economic health to the Euro area will not be easy.

There are also important “should” problems in the political realm. Should Europe be a centrally controlled entity, or rather a collection of essentially sovereign nation states? Getting agreement on this “vision“ issue will be hard enough. It will be made even harder by the fact that existing legal and political structures are being increasingly challenged by growing domestic pluralism and the need to adapt to globalization beyond Europe. The nation-state in many European countries is no longer a nation, and the sovereign state is arguably less powerful than it has been for centuries[5]. The danger will be that some European countries will choose to try to reassert national power, while others will accept the inevitability of ceding power to higher levels of government. There are grounds for serious conflict here as well.

“Could” problems are in principle less intractable because Euro area governments can change domestic laws and international treaties as they see fit. Yet, here too practical difficulties remain. One problem is that domestic governments are constrained by their own constitutions. While even constitutions can be changed, in Germany at least this would first need a popular referendum. A second issue has to do with the diversity of the membership of the Euro area and the need for unanimity in arriving at decisions. Given the complexity of the issues involved, some more effective mechanism for resolving dispute would seem essential. Third, the Euro area has no ex ante mechanisms in place for either “bailouts” or for “exit”. Like a marriage in medieval times, it was expected to last forever. This was rightly intended to avoid “moral hazard” and ensure “virtuous behavior” but it has left the Euro area without a Plan B now that Plan A has failed.

Going forward, all of this must be rectified. A final constraint is that there is a difference between the membership of the euro area and that of the European Union. Many policy changes that might seem required to support the Euro area will have institutional implications for other members of the European Union that they will not like. The discussions concerning European banking union provide good examples of such complications.

“Would” problems are always very difficult to manage, even assuming the other problems have been solved. Mustering the “will to act” to implement effective policies always implies confronting the forces of inertia, bureaucratic resistance in the face of uncertain

[5] See Daniel Innerarity (2010) “The transformation of politics: governing in the age of complex societies” Diversitas No 7, Peter Lang, Brussels

outcomes and vested interests who will lobby vigorously to maintain the status quo. The euro area clearly has ample measures of all of the above. However, in the euro area there are added problems as well.

First, is the problem of the so called "democratic deficit". This refers to the fact that there was never a broad, public debate at the time about the merits of establishing the Euro area. Due to this, and many other factors as well, trust in government has sunk to record lows in many Euro area countries. A second and related problem is that there is no true sense of the "system" and the need for "shared responsibilities" to preserve its benefits. Given this environment, it is not at all surprising that a mutual suspicion has arisen about the motives of both creditors and debtors. Evidently when people do not trust their own government, and trust other people's governments even less, the scope for effective international agreements must be much reduced. Finally, as David Marsh[6] has memorably pointed out (p 2) "There is a hole in the heart of the currency. No one is in charge". For various reasons, mostly historical, Germany refuses to take a leadership role consistent with its pivotal position in Europe and the Euro area.

Shortcomings of the Policy Response to Date

The influence of the "should, could and would" problems has led to some past policy decisions whose effectiveness could now be questioned. Looking forward, these same influences might continue to constrain policy effectiveness, not least if some earlier policy decisions needed to be reversed. Against this background, it is not surprising that the crisis spread from tiny Greece to large countries like Spain and Italy. Nor is it surprising that financial markets remain nervous.

Misreading the crisis as a sovereign debt crisis, rather than a balance of payments crisis, led to recommendations for fiscal tightening everywhere in the Euro area. While this might have been an appropriate recommendation for the debtor countries in the periphery, it also led to a serious underestimate of the effect this would have on domestic production. With creditor countries like Germany and the Netherlands meeting "debt brake" targets even earlier than legally required, the prospects for export led growth in the periphery were evidently reduced. A more appropriate response would have been fiscal expansion in the creditor countries, especially given the impossibility of nominal exchange rate adjustment.

[6] David Marsh (2013) "Europe's Deadlock" Yale University Press, New Haven and London

The authorities also underestimated the possibility of contagion and the potential for capital flight from larger peripheral countries. This has had a number of implications. First, the authorities have essentially done nothing to moderate the influence of the four structural factors tending to amplify capital flight from peripheral countries. Second, efforts made to erect firewalls between smaller (non systemic) and larger (systemic) peripheral countries have been inadequate. Third, this underestimation also meant that the amount of liquidity support promised to troubled countries was systematically insufficient, though there were other reasons for this as well. This deserves further elaboration.

Early attempts by the ECB to support peripheral sovereign bond markets by direct purchases foundered on strong German opposition. Special funds were then set up to provide liquidity (the EFSF and ESM) but their mandates were never clear and the resources they had directly available for liquidity support were small. The authorities themselves recognized this shortcoming, since significant efforts were made to find ways to "lever" up the funds available through offering government guarantees. However, this too foundered upon the recognition that, for some sovereigns, more contingent liabilities would pose an unacceptable threat to their credit rating.

The treatment of the liquidity problem in the case of Cyprus led to a previously unthinkable outcome. The support package offered by the Euro area partners was so limited that, even after unprecedented debt write-downs, it was felt necessary to impose capital controls. While preferable to a total collapse of the banking system, capital controls are porous, lead to corruption, invite charges of unfair application and slow down investment and economic recovery. The fact that most of the burden of the debt write-down fell on the Cypriot population was another reason for anticipating it would lead to a sharp economic slowdown. While depositors in other countries did not immediately engage in preventive deposit flight, they have now been sensitized to a new and important threat to their welfare.

Treating the funding problems of peripheral sovereigns and banks everywhere as solely problems of liquidity, rather than potential problems of solvency, was also a mistake. Sovereign debt restructuring was put off too long in some peripheral countries. If Greece in particular had been sent directly to the IMF for support, the need for significant debt reduction would have been recognized much more quickly. Facing up to similar problems in the banking system was also delayed in the periphery and has not yet even been addressed in core country banking systems. In effect, a Japanese rather than a Nordic approach was chosen to deal with banking problems, and this has had predictable results. Unsure of their own solvency, and even more unsure about the solvency of others, bank lending has been extremely weak almost everywhere in the Euro area.

There can be little doubt that the demand for loans has fallen as well. Yet, it is notable that small and medium size enterprises (SMEs), particularly in peripheral countries, have borne the brunt of bankers' fears about both illiquidity and insolvency. For Europe this poses particular difficulties. First, production in Europe is much more dependent on SME's than is the case in the United States. Second, SME's are much more dependent on bank financing since market based funding is much less developed, again compared to the United States.

A further shortcoming has been more tactical than strategic. There have been too many examples of decisions being made or suggested, only to be followed by recantation or qualification. The suggestion, made after "the walk in Deauville", that a Greek exit might be condoned, broke a taboo and invited speculation about the exit of others. The suggestion that small depositors might take a haircut in the restructuring of banks in Cyprus will have a similar effect. Changing views on bank restructuring and resolution, and in particular on who will pay (taxpayers or creditors, and if creditors which ones?) has added to the impression of a process not firmly under control.

Finally, encumbered as it was by its various heritage problems, the political leadership in Europe has had little choice but to try and "muddle through". Each stage of the unfolding crisis always elicited a policy response, yet there was always a sense that it constituted the least possible response and that policy was always "behind the curve". The fact that the policy reform process has always slowed down whenever markets became more confident gave further cause for concern. In short, policy thus far has been perceived by the market as "timid", a characterization that strongly encourages speculation and further testing of the limits.

More Effective Policies to Restore Market Confidence

The ultimate objective must be to restore and maintain total market confidence in the integrity of the euro area framework. The best solution would be to ensure that even small peripheral countries are no longer thought likely to leave the Euro area. Failing this, policies must try to ensure that similar concerns do not arise about elements of the framework that are more systematically important. Doing this will demand less policy timidity and more demonstrated resolution. In particular, the belief system that says peripheral countries are responsible for their own problems, and that those problems are manageable without cross border burden sharing, must be fundamentally challenged. Moments of market tranquility should not lead to the conclusion that total confidence has been restored.

Restoring confidence will pose shorter term challenges, essentially of better crisis management. It will also pose longer term challenges to prevent any possible recurrence of current difficulties. The economic systems of the countries in the Euro area, as well as the governance framework of the Euro area as a whole, need significant improvement. Simultaneous progress on all fronts could well have interactive effects on confidence that were greater than the sum of the parts. Similarly, if one challenge proved insurmountable (say explicit restructuring of past debts) then it would be all the more important to make progress on other fronts.

The place to begin is with a reversal or moderation of the crisis management tactics criticized above, a process which may already be quietly underway. The Euro area as a whole suffers from inadequate domestic demand, and creditor countries in particular should try to rectify this. While it is likely politically impossible to contemplate fiscal stimulus at this point, efforts could be made to address income distribution issues in Germany in particular. Lessening income inequality would help spur consumption as would higher wages after many years of restraint. Private investment has also been unusually low in many creditor countries for many years, and an attempt needs to be made to identify the reasons and to address them as quickly as possible.

Concerning the peripheral debtor countries, it should be recognized more widely how much fiscal restraint they have already enacted. In fact, for all of them, little more is generally required to put sovereign debt levels on a descending path to meet Maastricht criteria. Thus, any room for maneuver here should be exploited, not least by back loading further adjustment, in light of the progress already made. As in the creditor countries, policy measures should invite private investment. Not least, foreign direct investment should be strongly encouraged since such companies often have a much stronger export orientation than domestic companies.

Addressing the liquidity problems faced by peripheral sovereigns and their banks must be a high priority. Again, change has already begun. The facilities put in place by the European Central Bank have significantly eased the funding problems of most peripheral banking systems. The outflows of private sector capital from peripheral countries, largely reflecting the withdrawal of funds by core banks, have effectively been replaced by public sector inflows via the Target Two system at the European Central Bank.

Confidence in peripheral sovereigns has also been significantly enhanced by the promise of the ECB "to do whatever it takes" to maintain the integrity of the Euro area. However, this last initiative remains seriously incomplete since the promised backstop can be activated only if a country requests such support, and has already been promised support by the ESM. The danger remaining is that a run on a country will occur before help has been requested and the ECB will feel unable to act. This could easily set off a much wider crisis. Against the backdrop of the fiscal adjustment to date, this dangerous conditionality should be removed. In any event, it is "odd", to say the least, that a central bank should be imposing conditionality of this nature given all the other oversight and monitoring mechanisms already in place.

An inadequate resolution of possible solvency problems, banks and sovereigns in the periphery as well as banks in the core, continues to weigh on lending in the Euro area. Without a resumption of lending, especially to SMEs in peripheral countries, an economic recovery hardly seems likely. There should, in principle, be a Nordic solution to this problem. Above all, bad debts should be recognized and written off. In the Euro area, this would certainly mean a significant write-down of Greek sovereign debt, and possibly Ireland and Portugal as well. This would reduce the capital of core banks, but would also have a fiscal impact. Most of Greece's debt is now in public sector hands. There should also be a fresh and more realistic look at the value of other bank assets, as is expected to happen when the ECB conducts another set of stress tests later in 2014. When all of these losses have been recorded, then presumably banks themselves would be restructured – either recapitalized or closed down.

If this process happened, it would be a big step forward in that it would replace the current uncertainty with certainty. Yet, whether this will happen remains deeply uncertain. In the context of measures to promote "Banking Union" in Europe (discussed further below) agreement was reached in 2012 on the need to establish a Single Supervisory Mechanism at the ECB. Moreover, in July 2010 the European Commission proposed a Single Resolution Mechanism for the Banking Union. Yet, closer analysis reveals that these measures are solely intended to reduce the likelihood and costs of future crises. They leave responsibility for resolution and recapitalization, resulting from past errors, solely to national authorities. This implies that peripheral sovereigns would be left with a fiscal burden they cannot bear, and that core countries can continue to ignore the possibility that their own banks might have solvency problems. Thus, as of early 2014, the uncertainty carries on.

The whole approach to the Banking Union issue supports this conclusion. Banking Union is generally taken to imply the need for a single deposit insurance regime, a single resolution scheme and a single supervisory scheme. Had crisis management been at the heart of the agenda, the Commission would have begun with the first two of these, but it rather chose the third. Presumably this reflects the fact that it implies no significant degree of cross border burden sharing, whereas the first two do have such an implication. This whole approach also threatens to put the ECB in a very dangerous position. It is supposed to be undertaking objective stress tests of the larger banks in the European Union. However, absent credible plans to deal with inadequately capitalized banks, how can the ECB possibly say they are undercapitalized? The markets already recognize this dilemma and an ECB verdict of "good health" would do nothing to resolve the uncertainty. The only certainty is that the reputation of the ECB for honesty and integrity would take an enormous blow. It is vitally important that this "restructuring and resolution" issue be dealt with as soon as possible.

Finally, even if it would be right to rectify past shortcomings, it would also be more of the position shifting that was criticized above. Moreover, admitting to error is not something that anyone finds easy. One tempting possibility would be to make policy changes in ways that do not draw a great deal of attention. For example, the debts of small sovereigns that are publically held elsewhere in Europe might be replaced with very long term debt (infinite like British Consols?) at very low rates of interest. Another solution would be to put the focus on welcome changes in circumstances over time, particularly in the peripheral countries that justify a new set of crisis management tools. Not least, emphasis could be put on the massive amount of fiscal adjustment to date. As well, significant progress has been made in responding to the longer term challenges faced by the Euro area. These challenges are both institutional and structural.

In June of 2012, a document was circulated by Herman Van Rompuy that finally articulated clearly the need for institutional reforms. The crisis had shown that the original framework was fundamentally flawed, and would lead to a permanent "transfer union" that no one wanted. Fiscal and financial oversight had to move to the centre, if the Euro area were to be properly governed, and this implied the need for three sets of reforms. First, efforts had to be made to establish a fiscal union, with much stronger rules for domestic fiscal positions and potentially even a much larger centralized budget. Left unstated were prospects for jointly guaranteed euro bond issues. Second, efforts had to be made to establish a banking union, along the lines described above. Third, there would have to be significant steps towards political union, with more sovereignty ceded to central institutions like the European Commission or the European Parliament. If one can trust the argument that a problem recognized is a problem half solved, then this constituted a major step forward.

Yet, implementation of each individual form of union will be very tough in the face of the "should, could, and would" arguments referred to above. The announced approach to banking union could be just a sign of the difficulties to come. Moreover, there are interlinkages between these reforms that will make their implementation even harder. As noted above, how can there be banking union without some form of fiscal union that involves cross border burden sharing? In turn, how can there be fiscal union without a commensurate transfer of political power to ensure the appropriate degree of governance? Distributional issues are, after all, quintessentially political. Harold James[7] has noted that the needs for these different forms of union were recognized by some as far back as the 1980's. Unable to bring others along with them at the time, those wanting stronger governance processes took comfort in the thought that future difficulties would make further reforms more likely. It still remains a hope and not yet a certainty, a quarter of a century later, that the current crisis will provide sufficient political motivation to complete the process of institutional reform.

The structural reforms needed in the Euro area will be applied at the level of member states. However, taken all together, they constitute the pursuit of an "economic union" to go along with the three other "unions" just noted. One reason for wanting this is that national rules and practices in the economic (and financial) spheres still differ widely. After all the decades that have passed since its foundation, the European Union is in fact very far from being a single market and the benefits that the single market could bring have not yet been achieved.

In addition to fostering more cross border competition, structural reforms could bring many other benefits. Labour market reforms, product market reforms, reform of government services and a whole host of other reforms would lead to lower prices, faster growth and lower unemployment. These are good things in themselves. Moreover, for indebted countries they also make debt service more manageable. Thus structural reform in peripheral countries would benefit both debtors and creditors.

Within the Euro area, structural reforms could also help in reducing remaining current account imbalances. Policies to support exports in debtor countries would be welcome, not least removing impediments to firms increasing their size. It is well established that bigger firms are more innovative and pursue export markets more systematically. Similarly, creditor countries should reduce impediments to the growth of firms orientated to the production of services and non tradable. New product opportunities internally could encourage a welcome shift of capital away from export orientated industries.

Yet, as with the longer run institutional challenge, structural reforms still face challenges from the "should, could and would" problems. Effective structural reforms demand a planning process that sets out economic priorities and an implementation strategy that considers issues of sequencing and timing, especially with respect to legislation. It is also important that reforms are consistent with any need for future fiscal consolidation. Perhaps even more important, successful structural reforms demand broad political support. In gaining such support, national

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[7] Harold James (2012) "Making the European Monetary Union" The Belknap Press of Harvard University Press, Cambridge, Mass.

governments must convince the population of the need for change. As well, they must use available carrots (an enhanced status within Europe?) and sticks (failure could lead to chaotic outcomes?) to get the public on their side.

It is also crucially important that suggested reforms are seen as fair, and that vested interests are being confronted in the best interests of the country as a whole. "Trust" in government is essential in such circumstances to avoid fears of one set of vested interests simply being replaced by another. Unfortunately, in many Euro area countries today, that "trust" is conspicuous by its absence. This perhaps explains the recent recourse to "technocratic" governments in a number of the peripheral countries of the Euro area. Of course, in democratic societies, this approach must also have its limits.

Alternative Scenarios for the Euro area

Given the complexity of the situation, both economic and political, a wide variety of outcomes are conceivable. They are described below as orderly, disorderly and very disorderly. Key to achieving more desirable outcomes will be resolving the "should and would" problems in the creditor countries. Both the governments and the voting public must agree that the heritage problems of excessive debt cannot be dealt with without more debt write offs, and without some degree of cross border burden sharing. The recent treatment of Cyprus was a step forward concerning the first issue, but certainly not the latter. Looking forward to preventing further crises, there must also be institutional and structural reforms within the Euro area. Crucially, they must be sufficient to convince the citizens of core countries that this restructuring was truly a "one off" and not the beginnings of a permanent transfer union from the centre to the periphery. In Germany in particular, still bearing the scars and the costs of German reunification, this will be a tough sell.

The most optimistic possibility, an "orderly outcome", is that the current state of market confidence continues and strengthens. The European authorities have made a lot of policy changes, indeed many great sacrifices. This might suffice to attract increasing levels of private sector capital back into peripheral countries as well as to restart bank lending more generally. Ongoing discussions about various longer term reforms might be judged promising in themselves, and indicative of a capacity to produce still more reforms going forward.

Unfortunately, a second scenario, a "disorderly outcome" is also possible. The Euro area could prove vulnerable to a further lack of confidence that could be triggered by a wide variety of economic or political events. Credit spreads would widen and bank funding become more difficult. This would demand and would get a policy response. Should the more effective policies discussed above then be implemented forcefully, confidence would be more likely to return and the Euro area would also be much better placed to sustain confidence going forward. It is of particular importance that the new policies put in place would give hope to peripheral countries for an eventual resolution of their difficulties. Austerity policies that are "more of the same" could temporarily reassure financial markets, but only at the price of growing social and political unrest. This would be a recipe for the "transfer union" that no one wants and that would inevitably explode.

The third possibility is for a "very disorderly outcome" in which countries decide to leave the Euro area. As described above, this could be due to a loss of market confidence and needed euro liquidity, or could be the result of a rational evaluation of the costs and the benefits of leaving. Whatever the trigger, there would be a tendency for currency appreciation and deflation in creditor countries and depreciation and potentially high (or even very high) inflation in debtor countries. Banking systems would likely fail everywhere, including in the creditor countries, as debtors failed to meet their debt service obligations. Two versions of this very disorderly outcome can be suggested.

On the one hand, debtor countries could choose to leave. This could well spark contagion, would likely incite hard feelings with creditors, and would also lead to enormous legal uncertainties about the status of debts denominated in euros that countries with new (and depreciating) currencies could no longer service. On the other hand, creditor countries could choose to leave. Historically, when currency unions have broken up, this has often been the route chosen. In a recent article, George Soros called on Germany to "Lead or Leave"[8]. Were creditors to leave, and establish a new currency, this would obviate the legal uncertainties since the debtors would continue to have service obligations in their own currency, the euro. Further, creditor countries would have an incentive to cooperate with the debtors to avoid large exchange rate changes that would increase the creditor's losses. As the English might put it, "The best of a bad job", but of course a "bad job" nonetheless.

[8] George Soros "Why Germany should lead or leave" Project Syndicate, 8 September 2013