How to run the euro area

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At the root of the euro crisis was not only a sovereign debt crisis, but also a balance-of-payments crisis. A multifaceted approach is required to restore the euro area economy back to a sustainable growth path.

The euro area (eurozone) crisis has often been characterized as a sovereign debt crisis. Indeed, it was triggered by a sudden loss of market confidence in the sustainability of Greek government finances. Similar doubts quickly spread to Portugal and Italy.

For some other countries that were subsequently hit by the crisis, however, the root cause lay in persistently above-average price inflation driven by a build-up of private-sector debt, notably in Spain and Ireland where the problem was exacerbated by housing market bubbles. This was financed essentially by borrowings from banks which in turn relied on capital inflows from abroad.

Localized troubles became systemic as they were transmitted widely by a highly interconnected and under-capitalized banking system.

Exacerbating these developments were concerns in financial markets that the potential unsustainability of some sovereign debt and the political costs of adjustment could cause the break-up of the euro area itself.

In a number of euro area countries with a history of frequent devaluation against the German mark, deeply embedded expectations of higher inflation than the European Central Bank (ECB) was ever likely to permit persisted even after they joined the euro area. The consequence was substantial reductions in local real interest rates.

These led to sharp rises in not just demand for housing but also consumer and business spending more generally. The end result was wage and price inflation out of line with the euro area average, implying a deterioration of international price competitiveness and unsustainable balance-of-payments imbalances.

No longer able to adjust nominal exchange rates to regain international competitiveness, those countries were forced by financial market pressure to correct external imbalances by deflating domestic demand. This involved both extensive nonfinancial sector deleveraging and harsh fiscal consolidation.

Especially in those countries where nominal wage rigidity has been particularly strong, wage and price deflation to achieve external adjustment has been realized at the heavy cost of depressed economic activity and rises in unemployment to socially unbearable levels.

A multifaceted approach is required to prevent a vicious circle of public- and private-sector deleveraging leading to weaker economic activity, which in turn results in a further deterioration in banks' asset quality. The consequence would be tighter credit supply which would further delay economic recovery.

As concerns governments, the following four challenges stand out:

A resilient and healthy banking system supportive of growth requires transparent accounting that avoids surprises like that recently reported by the Italian bank UniCredit. It also requires far stronger equity capitalization of large banks than exists today and separation of large, high-risk derivative portfolios from the deposit banking activities of the core monetary system. A credible banking union must include at least the full euro area membership.

To the extent that the roots of the crisis are related to divergent trends in competitiveness and productivity, macro-economic policy approaches need to be complemented in many countries by micro-economic reforms.

In particular, given the threat to the viability of the euro area as a whole arising from divergences between France and Germany, the French government needs to build public support for fundamental structural reform. This includes support for measures which contribute to a better functioning of product, services and labor markets, and not just those limited to financial markets. In some countries it also means shifting resources within public budgets from transfers to productivity enhancing investments.

Most importantly, relying on nominal demand deflation and specific micro-economic reforms to restore competitive positions in countries on the periphery is not enough. Governments must establish a reliable legal and regulatory environment and a general economic and social climate that is conducive to investment, innovation and risk-taking.

Moreover, competitive forces operating across the whole euro area, especially in labor markets, must be strong enough to ensure that cross-county divergences in cost competitiveness do not simply re-emerge as soon as growth and activity recover.

As creditor countries such as Germany still have very high debt/GDP ratios and expect pressure on public budgets to increase in the future, it would not be wise to recommend to them to give up on budgetary discipline. But these countries should take the lead in micro-economic reform at national level and in further opening and deepening the Single Market at the European level.

Turning to the ECB, its monetary policy can play a major role in facilitating the adjustment process by sticking to a "symmetrical" approach, in particular avoiding any deflationary bias, to stabilizing price inflation at or around 2 percent for the euro area as a whole. This will allow for enough short-term divergence in cost and price inflation across the region to restore a more sustainable configuration of competitive positions.

At the same time, it will reinforce the ECB's credibility and narrow divergences in longer-run inflation expectations in individual member countries in the euro area, aligning real interest rates in them closer to the area average.

Finally the ECB should definitely return to its initial mandate regarding monetary policy and leave the bailout of governments, if needed, to the European Stability Mechanism) and other European institutions.

Members of the euro area have to recognize that the price for sovereignty is full liability for national fiscal decisions and full responsibility for the results of national economic and social policies in terms of economic growth, employment and competitiveness.

A multifaceted approach is required to prevent a vicious circle of public- and private-sector deleveraging.

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