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A two-speed Europe revisited

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The EU summit achieved a number of things of both in terms of fiscal discipline and crisis measures. Still, a major missing piece is the treatment of countries that find difficult to exercise fiscal discipline due to their own economic structures. While there is a claim that such countries should exit from the EMU, in order to prevent contagion of financial stress to the "core" countries, such idea has serious problems in practice. It would rather be the second best solution for the EMU to keep troubled nations to within the EMU while wavering for fiscal discipline based on objective, explicit, and in advance guidelines.

What have been achieved:

Participants of international financial market criticized the agreements at the EU summit a month ago, claiming they consist mostly of "plans" and "scheduled" actions and are neither fast-acting nor concrete. But the progress made on the central issue of strengthening fiscal discipline in Europe may, in retrospect, be seen as a meaningful step forward. Let me briefly review their major achievements.

(1) Fiscal Discipline

Restoring fiscal discipline was a key focus at the summit. And it simply requires that countries rein in their budget deficits and avoid the build-up of large amounts of debt. In the discussions that preceded the summit, suggestions were made on ways to make the existing framework, the Stability and Growth Pact (SGP), more effective.

Reportedly, a number of proposals would be incorporated into a new agreement of the pact, including (1) pre-approval of national budgets by the European Commission, (2) advance notification of national bond issuance plans, (3) caps on structural fiscal deficits, and (4) automatic application of penalties for countries.

While the markets appear to remain skeptical of the newly agreed initiatives, in part because the SGP has been so ineffective over the years, the unusual sense of urgency observed among European leaders are welcome. And I think it is significant that this time talks were carried out within the (admittedly nonspecific) context of building a road to fiscal union, which marks a new stage.

(2) Crisis Measures

EU leaders also needed to present effective short-term measures to stem the crisis. It was clear that existing facilities would eventually run out of funds in the course of providing fiscal support for debt-laden nations and restoring market stability. But the plan for leveraging the EFSF ran aground after garnering little interest from global investors. Meanwhile, the ECB bought limited amounts of government debt under the constraint of a prohibition against financing government deficits, but that did not appear to be a very sustainable approach to the crisis.

Attention focused on a proposal to expand the scale of the EFSF by increasing the size of the debt guarantees provided by Euro-area governments. But the turmoil in government bond markets then spread to the core countries of the EMU, raising questions about how much debt these countries could guarantee. Indications that the rating agencies would respond with sovereign downgrades also undermined the viability of this proposal. Instead, attention shifted to a proposal for the ECB to supply more funds. This plan would have the ECB loan the funds needed for the EFSF and/or IMF to address the crisis.

In part because of strong opposition from the ECB, leaders at the summit revived the plan to leverage the EFSF. Given the difficulty of accomplishing this in the short term, it was proposed to move up the adoption of the ESM by about one year and to maintain the ability to provide about €500bn by keeping both the ESM and the EFSF in existence for the time being. Financial markets had responded favorably to this idea.

It was also proposed that Euro-area countries contribute about €200bn to help fund the IMF's support for debtor nations. While it risks increasing the fiscal burden on these countries, this plan has certain advantages. Since the IMF can be expected to provide a measure of governance, it could make it easier for third-party nations such to contribute funds than by going through the EFSF.

The missing piece:

Even if the Treaty could be successfully revised to reflect the agreements and the Stability and Growth Pact (SGP) would be administered more rigorously, however, certain countries will probably find it difficult to exercise fiscal discipline—some may even have found it difficult to do so under the more favorable economic conditions obtaining prior to the financial crisis. This is not a question of ethics or right and wrong, nor a claim that this situation will persist forever. It is simply an acknowledgement that, at least for the time being, it will be difficult for some countries to exercise fiscal discipline given an objective look at their economic growth potential, external competitiveness, and existing fiscal structures. And the results of the EU summit do not appear to offer any meaningful response to this "inconvenient truth".

While some in the markets have recommended that distressed countries should leave the union, I could point out the practical difficulties. I therefore reexamine the issue, taking into account the agreements reached at the EU summit.

Where the EU exit argument breaks down:

A number of comments made by European leaders around the time of the EU summit suggested that fiscal union was the ultimate prescription. However, I think it will be difficult even for EMU members to reach an early domestic consensus on this issue. And if we assume that these countries are capable of clearing certain fiscal hurdles, at least in theory, they probably satisfied the conditions required for an optimum currency area from the outset. Any discussion about strengthening fiscal discipline is implicitly drawing lines for an optimum currency area and is effectively saying that the EMU should consist (only) of countries fulfilling these conditions.

Their implication, at least in theory, is that it would be dangerous for countries capable of meeting fiscal targets to allow countries incapable of meeting those targets to remain EMU members. Doing so would not only undermine the market's confidence in the multilateral agreement for fiscal discipline but would foster speculation that countries meeting the criteria would ultimately have to support those that do not. That could trigger contagion, with market perceptions of even the fiscally disciplined nations taking a turn for the worse.

But that is not to say that countries incapable of meeting these standards should be forced out of the EMU. The worry is that an increased risk of a country leaving the EMU will trigger a major shift of that country's domestic assets into the euro (ie bank runs), prompting a collapse of the financial system and complicating efforts to rebuild the economy. Of even greater concern is the scenario in which a country's exit from the EMU fosters speculation that other countries in similar economic circumstances will also leave eventually, thereby destabilizing the financial systems of those countries. In that case, countries initially capable of meeting fiscal targets may be forced to provide support for distressed nations or may themselves become victims of such speculation, leading again to a broad-based crisis.

Here, it could be argued that such countries in trouble temporally join the "small union" consisting of the UK and a few nations of the EU which expressed concerns about the reform of the Treaty. We should remember, however, none of the nations of the group is a member of the EMU. If a country were to exit from the EMU and join such group, its currency would need to be changed and could trigger the same set of serious problems for outright exit from the EMU.

An alternative prescription: currency devaluation and some waivers for fiscal discipline

The question then becomes what to do about countries that, as a practical matter (and not out of ill will or wrongdoing), cannot meet the fiscal targets. If we think about this issue from the opposite direction, these countries must eventually adopt a prudent approach to fiscal policy whether they remain within the EMU or strike out on their own. And given many economies that did so successfully in the past, we should not make the a priori assumption that Europe's debtor nations will never put their fiscal houses in order.

Even if these countries could one day join the ranks of the fiscally prudent, the question is how to cope until then. One idea that seems to have a fair bit of support from the markets is to separate these nations from the EMU, enabling them to use exchange rate flexibility as a policy tool, and bring them back into the fold once their economies recover. To be sure, exchange rate policy is the only viable policy tool from a macro perspective, given how low interest rates are and how little scope countries have to deliver fiscal stimulus. But it is important to remember that this would be a one-time-only option. If the currency continues to decline in value, the situation would be no different from one in which the country had simply left the EMU, and it would be extremely difficult to bring it back into the Union. If the exchange rate is to be lowered just once and then stabilized at the new rate, the EMU might have to engage in "unlimited" currency intervention, selling EUR and buying that nation's currency. Unlimited selling is technically possible since EUR is the EMU's domestic currency, but whether it could be maintained over the extended period of time needed for the country to complete structural adjustments, is another issue entirely. In the worst-case scenario, the market totally lose the confidence in EUR.

In the end, a more pragmatic option may be for the EMU to embrace nations that would have difficulty meeting fiscal targets at present and offer fiscal discipline "waivers" while promoting economic growth, external competitiveness, and structural reforms to enhance fiscal health. Apparently, this is not the best option, and separate measures would be needed to minimize the risk of contagion.

What is important in this regard is to ensure that the terms of the waivers are set out objectively, explicitly, and in advance. In the event that some nations are unable to meet the targets, it should be made clear that the terms of the waivers do not indicate a relaxation of fiscal discipline in the broader EMU. Specifying the terms should also help prevent moral hazard due to countries that are actually capable of meeting the targets neglecting to make the necessary effort.

It will also be important to spread the cost of helping fiscally distressed countries around the globe. From a moral perspective, it probably makes more sense for other European countries to support the region's troubled debtors, and there would probably be significant political hurdles to the use of taxpayer money outside the EMU to help such countries. But developments in the European crisis since this autumn suggests there is highly uncertain whether that the EMU could support all the distressed nations. There has been a sign of contagion, with financial stresses spilling over into countries that had no problems to begin with.

In that sense, the direction of the recent EU summit made it clear that there are certain advantages to organizing global support around the IMF as we reviewed above. In terms of managing the debtor nations, giving the IMF responsibility for economic policy governance would make it easier for third-party countries to offer financial support. In particular, the subjective risk involved in providing financial assistance could be minimized inasmuch as third-party countries that are also large contributors to the IMF have the ability as stakeholders to exert some control over assistance offered by the Fund. This would not be the case if financial support were channeled through other regional vehicles.

Conclusion

Readers may be disappointed that we have come to the less-than-interesting conclusion that troubled debtor nations should be kept within the EMU fold while undertaking efforts to curb contagion. There is little I can say in response other than to suggest that if efforts are made to prevent contagion and promote longer-term economic rehabilitation, both the market's reaction and the actual results are likely to be different than if no such efforts are made and countries are kept within the EMU only because there is no other alternative.

In any case, Europe seems to have a long list of issues that must be addressed going forward.

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