The consequences of a Euro collapse for both the Eurozone's core and periphery are so dramatic, and their ramifications so uncertain, that all efforts should be made to shore up the European Monetary Union.

May 12 2012

What is the solution to the Eurozone crisis? It is certainly not in allowing the Euro to weaken or collapse, according to **Manuel Muniz** *and* **José Carlos Alcázar**. *They argue that Europe has the capacity to fix the Eurozone, and that Northern European economies must accept that they need to provide the necessary resources to help others those in the periphery reform their economies and prosper.*

Countries in the periphery of the Eurozone face one of the toughest dilemmas in recent history. Each of them with their particularities, Greece, Portugal, Italy and Spain all share the challenge of dealing with the consequences of sustained large current account deficits, the accumulation of public and private debt and a protracted banking crisis. On top of these troubles, they lack an independent monetary policy, possess minimal fiscal maneuverability due to already unsustainable levels of public debt, and have to work under a marked sense of urgency due to painful and untenable unemployment rates.

Their dilemma is over whether to implement further structural reform in the frame of the Eurozone, knowing that these measures could take longer to take effect than what is politically acceptable, or exit the Euro in order to regain competitiveness through a sharp currency devaluation and face huge upfront costs and an uncertain future.

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Regaining competitiveness in a non-devaluation and non-inflation environment like the Eurozone is extremely complicated and, if achievable at all, will require long term structural reforms. However, although devaluation might seem to be an attractive option, it is uncertain if it would produce sustainable gains in competitiveness. Currency devaluation would reduce the pressure to face much needed reforms and would be particularly hurtful to import dependent economies. Given that Greece, Italy and Spain's external dependence is significant, devaluation would produce high inflation and a collapse of purchasing power. Inflation would undoubtedly reduce long term gains in competitiveness over time. Furthermore, with a weakened currency it is doubtful these countries would be able to attend to their Euro-denominated debt payments. Some form of debt re-denomination, re-structuring or even default would ensue. Therefore, not only would the national economies of the periphery suffer in such a scenario but the systemic effects would be incalculable.

Meanwhile, current account surplus countries at the core of the Eurozone like Germany face a different dilemma: Either keep the economic benefits of the Economic and Monetary Union (EMU) at a cost of committing enormous economic transfers to countries in the periphery, or allowing those countries to go bust and, possibly, seeing the end of the common currency. Three factors are pushing in the direction of allowing the second scenario to become a reality. The first is the notion that wealth transfers to less competitive Eurozone economies are bound to exceed the economic benefits of the EMU over time. The second is the fact that, even if supporting the EMU was a financially wise decision, public support for further transfers of wealth is waning and cannot be taken for granted. Third, large transfers of wealth will imply ceding sovereignty to European bodies. This is bound to be met with resistance from growing sections of the political spectrum and in some cases even from Constitutional courts.

However, allowing the weakening of the Euro, let alone its collapse, would surely be an extremely costly move for countries at the core of the single currency. Germany alone has committed over €200 billion in both direct funding and credit guarantees to the European Financial Stability Facility (EFSF) and to the European Stability Mechanism (ESM). Out of the €750 billion of combined EFSF and ESM lending capacity, close to €190 billion have already been allocated to Ireland, Greece and Portugal through bailout programs. Added to that should be the over €550 billion worth of Euro-denominated (and non-German) sovereign debt in the hands of German investors. In addition, the Bundesbank has deposits at the European Central Bank (ECB) worth around €650 billion. Those deposits have, in turn, been lent to the National Central Banks of current account deficit countries through an ECB mechanism called TARGET 2. Added to that should be the €1 trillion directly lent by the European Central Bank to financial institutions across Europe in its latest Long Term Refinancing Operation (LTRO). Spanish and Italian financial institutions alone owe around €500 billion worth of LTRO money to the ECB. And lastly, we should also remember that the ECB is the proud owner of close to €250 billion worth of sovereign debt from troubled Eurozone countries, mainly Greece, Portugal, Italy and Spain, which it acquired through its Securities Market Program (SMP). Any development that puts the solvency of the ECB at risk should cause worry for stakeholders, particularly to those that stand to lose the most. Like Germany.

It is evident that countries in the core and periphery of the Eurozone face very difficult decisions. Overall, however, the options are clear: Further commitment to the single currency with reforms in the periphery and strong wealth transfers from the core, or keeping the single currency at risk and, quite possibly, allowing for its demise. It is our assessment that the consequences of a Euro collapse are so dramatic and their ramifications so uncertain that all efforts should be made to shore up the EMU.

Europe: Moving from a solution to a new dilemma

Currency areas are rarely born out of natural economic circumstances. They are launched and shaped, primarily, by sustained political will. The Euro was no exception. If the Eurozone is to survive the present crisis, strong and concerted action is needed. Inaction is not an option.

Countries in the periphery of the Eurozone are abiding by budget cuts agreed to in negotiations with other Eurozone partners. Some of these austerity programs are the strictest in living memory. Furthermore, countries in the periphery are well on their way to implementing serious reforms to boost productivity and streamline the labour force. However, from a Eurozone perspective, focusing solely on imposing austerity on the periphery, and waiting years for reforms to take effect, will almost certainly prove insufficient.

Northern economies have to accept that they need to provide the necessary resources to help others in the Eurozone reform their economies and prosper. Such transfers are ordinary in successful currency areas. If done properly and in conjunction with structural reforms in the receiving economies, this should produce a convergence in productivity across the monetary union. In this scenario, we would not expect the periphery to suffer decades of high financing costs, experience two digit unemployment rates and social unrest. It is time, therefore, for the core of the Eurozone to renew its commitment to the single currency.

In order to optimize the EMU we would like to propose three measures, ordered by their urgency.

1. The creation of a European Troubled Assets Relief Program (ETARP) to restore the balance sheets of financial institutions across the Eurozone, especially those in the periphery. This mechanism could be created within the ESFS/ESM structure. Overall funding for ETARP should be sorted out at a later date, but it is estimated that Spanish financial institutions alone will need around €100 billion in additional capital in order to offset declines in their asset values. ETARP would inject capital into European banks restoring confidence in their sustainability and kick-starting a more robust lending cycle.

2. The creation of Eurobonds and a European treasury. There is an urgent need for the launch of a safe asset that can guarantee the basic funding needs of all Eurozone members. Such an asset should take the form of a European bond with some form of joint guarantee from all Eurozone members. In order to reduce the risk of moral hazard, it would be ideal to follow the so-called 'Blue Bond' proposal and limit the amount that Eurozone member states can obtain through Eurobonds to a certain debt-to-GDP ratio. The rest of their financing needs would be covered through national or 'Red' bonds.

3. The creation of a European Unemployment Fund (EUF) and strengthening the European Labour Policy. The EUF would be composed of contributions by the different Eurozone countries according to their GDP, population and previous year unemployment levels. Unemployment subsidies in every country of the EMU would come from the EUF. In parallel to this measure, we would also need to see an important transfer of sovereignty to EU (or Eurozone) bodies so that they could work on the optimisation of the labour market across the EMU. We believe these measures would (i) produce a major shift in the perception of unemployment as a problem of the single market rather than as a strictly national problem, (ii) improve labour markets within the Eurozone, (iii) improve labour mobility in the currency area, particularly from 'labour deficit countries' to 'labour surplus countries'.

The current situation in the Eurozone is extremely complicated; but extreme situations have advantages too. The current state of affairs will allow, and encourage, governments in the periphery to make reforms and take measures that would have been politically unacceptable otherwise. And it will progressively push countries in the core to commit to the fiscal integration that the Eurozone requires. Therefore, it should not come as a surprise to see the current tensions in the periphery subsist for some time before the conditions are set for a move towards a fiscal union that is perceived as fair and sustainable by everyone.

What seems clear, however, is that Europe has the capacity to fix the Eurozone and that it would be a catastrophic mistake, and a manifestation of a total lack of vision from European leaders, to let the single currency fail without first employing all the tools available to save it. The tools available today are none other than deep reforms in the periphery, wealth transfers from the core to reinforce those reforms, and an overall more effective plan for European economic governance. The European dilemma will force everyone to make tough decisions, but the best path to follow is to work together and to deepen European integration.

This article first appeared at Politics in Spires.

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