The Euro crisis threatens not only the common currency, but also the future of the European Central Bank

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Since the beginning of the crisis, politicians, governments and institutions have scrambled to preserve the Euro. ***John Doukas*** *argues that not only is the common currency in danger, but also the European Central Bank (ECB) which has a balance sheet that consists of the debt obligations of member governments and their banks. But who will bail out the ECB?*

The Eurozone has been in turmoil since the 2008 financial crisis. The overarching question is: Will the Euro survive? Currently, European political leaders are constantly made aware of the continent's economic woes and they continue to buy time with short-sighted measures which, in essence, prolong the crisis. I call this "political misfeasance".

The sovereign debt problems of Greece, Italy, Portugal and Spain, financial calamity of the public sector, along with the banking crisis of Ireland have unmasked the underlying problems of the Euro and the weakness of the European Central Bank (ECB). To see the flaws of the ECB one needs to compare the US to the Eurozone. In the US the states finance themselves by selling bonds mostly to institutional investors (i.e., mutual funds and insurance companies). These state bonds are not bought by banks and, hence, they are not held by the Federal Reserve, the ECB equivalent in the US. These state bonds trade at interest rate premiums reflecting default risks of the various states. The Federal Reserve conducts its monetary policy through its open market operations (i.e., buying and selling US Treasury bonds issued by the US Treasury on behalf of federal government). Although the bonds of US Treasury are not default free, they are mostly perceived as risk-free assets in the markets.

European Central Bank Credit: Jim Woodward (Creative Commons BY)

The US Treasury bonds, then, appear as a (safe) asset in the balance sheet of the Federal Reserve. In contrast, the asset side of the ECB's balance sheet consists of debt obligations of member governments and their banks. Currently, the ECB holds more than €1 trillion in loans and bonds owned by member states and their banks. European Union (EU) member governments fund their deficits mainly by issuing and selling bonds to banks in the Eurozone and the banks fund themselves to a certain extent by borrowing from the ECB using the Euro member governments (i.e., Greek, Italian, Irish, Portuguese, Spanish) bonds as collateral. This has served as a cheap and easy funding mechanism for the weaker EU member countries. As a result of this and the erroneous perception by capital markets that Euro member countries become equally risk-free with the introduction of the Euro (i.e., uniform sovereign risks across the Eurozone), the peripheral countries experienced lower interest rates and increasing current account deficits as the demand for non-tradable assets (i.e., real estate and imported consumer goods) increased over the years. That is, capital markets assumed that – since these countries are in the Euro area – there is neither an exchange rate risk nor default risk.

For example, Greek 10-year sovereign bonds in 1993 had a yield just under 23.3%. By 1999, that yield went

down to 6.3% which means that the demand for Greek government debt increased dramatically. This demand came from abroad and this is also true for Italy, Ireland, Portugal and Spain. The flood of this money explains the huge current account deficits, the rise in prices and wages in the peripheral members of the Eurozone. In brief, the bulk of the assets in the ECB balance sheet are loans secured by government bonds. However, these bonds represent stressed government debt and if this government debt were to be restructured at a 50 percent to 60 percent discount, the ECB would face a huge problem – the ECB would become insolvent and raises the question of who is then would then bail out the ECB if the weaker Eurozone member countries experienced a severe sovereign haircut. The likelihood of sovereign default raises the survival of the ECB. It can be argued that this is a remote probability, but it is important to note here that sovereign defaults, though rare financial events do occur all the time.

So what needs to be done? Issuing Eurobonds is a must for the survival of the Euro, the ECB and the Eurozone as a whole, and opens the door for the creation of the much needed EU treasury, a fiscal authority that would be similar to the US Treasury. The Eurozone governments have already given up their monetary sovereignty for the sake of a single currency; the creation of a fiscal authority for the Eurozone requires giving up fiscal sovereignty, too. The Eurobond has to become the primary ECB asset. Currently, the ECB does not hold a risk-free asset and, hence, the foundation of the Euro as a currency is weak. It would not be an exaggeration to state that the ECB is insolvent as long as a number of member countries continue to be in an insolvency state. The issuance of Eurobonds by the EU fiscal authority (EFSM), will allow the ECB to replace its risky government bonds with Eurobonds, a risk-free asset. Until that happens, the markets will doubt Euro experiments and the entire Eurozone will be at risk. In sum, there has to be fiscal convergence leading ultimately to political EU integration for the survival of the Euro and the Eurozone as a single economic entity.

Italy is a good example of how sovereign states can integrate. This is not an easy process, but feasible. It took three wars for Italy's seven sovereign regions between 1848 and 1870 for the country to converge to a sovereign state with a single currency, central bank and fiscal authority. The seven different debts were converted to a common debt and while initially, this led to an increase in the borrowing cost of Naples (today's, Germany) the most healthy region back then, the Italian yields decreased over time.

While the introduction of Eurobonds is a short-run necessity, member counties with large sovereign debt problems need to undertake major structural changes to enhance their international competitiveness. This requires that they:

- substantially reduce the size of government sector which is responsible for the financial calamity of the periphery member countries;
- subject all elected politicians to a one or two term limits and get rid of their legal immunity;
- free up human capital;
- reduce taxes;
- boost capital formation;
- encourage private entrepreneurship; and
- create an attractive foreign investment environment through tax free economic zones.

All this requires political leadership and until it occurs, the Euro experiment will be treated with deep skepticism. Northern Eurozone countries, particularly Germany, will temporarily benefit from the debt crisis as a result of the capital flight-to-safety further delaying the undertaking of drastic measures to speed up the economic integration of the peripheral countries with the rest of the Eurozone. This might increase further the existing economic gap between the core and peripheral economies of the Eurozone as the cost of borrowing for investing in the latter will continue to be higher. This, in turn, will make these countries even more unattractive to invest forced to live with high rates of unemployment which might lead to social disruptions that could spread to the entire Eurozone.

For the time being, the ECB seems to prefer inflation by printing Euros. However, this policy choice is a covered (partial) default because it reduces the purchasing power of creditors and acts as a tax (lower

wages) on the general Eurozone population. The irony, today, is that the Euro was introduced in order to avoid inflation!

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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