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Is the Eurozone Heading Towards A Breakup?

Countries across Europe are reeling under a debt crisis. The Euro is under pressure because many countries don't satisfy the parameters needed to be in the Eurozone

by Gita Gopinath | Dec 20, 2011

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The health of the Eurozone is dire. What started out as a sovereign debt crisis in a minor periphery economy of the Eurozone, Greece, has now morphed into a full-fledged crisis involving the giants — Italy and France. It was always clear that if the crisis spread to these bigger economies there would be very few credible tools to prevent a meltdown. But here is where we are now. So which way forward?

The markets need to be persuaded that there is no reason to panic wholesale. The shortage of liquidity should not push solvent economies into insolvency. Italy cannot remain solvent if it has to borrow at interest rates over 7 percent. The European leaders have done extremely well at sticking their heads in the sand and waiting for the problem to explode. So, is there any room for optimism? In my opinion, there are a few rays of hope.

One is the positive development on the political front. The replacement of Silvio Berlusconi with Mario Monti deserves a global cheer and the appointment of Lucas Papademos as prime minister of Greece is also a plus. Both have a good understanding of the economics at play and have the right vision for reform: Fiscal prudence and growth-enhancing reforms to reduce debt to income ratios. At the minimum, Monti will make a better negotiating partner with Germany and France than his predecessor.

Two, it appears that the European Central Bank (ECB) will embrace its role as the 'lender of last resort'. The ECB has the capacity to bail out the sovereigns and the banks since it can print all the money it requires. The two arguments for withholding large-scale buyouts by the ECB are the fear of inflationary pressures and the creation of moral hazard, the legitimate concern that if it offers to buy out the debt then this will limit pressure on the troubled economies to undertake much-needed fiscal reform.

The change in leadership at the ECB with the replacement of Jean-Claude Trichet with Mario Draghi has tilted the stance of the ECB towards more pragmatism and less of an obsession with inflation fears. This is evident in the interest rate cut that Draghi instituted soon after taking over and the recent statement where he offers a quid pro quo: In exchange for aggressive deficit tightening, the ECB will consider aggressive intervention in buying troubled sovereign debt and thereby placing a ceiling on interest costs.

More broadly, the recent joint intervention by the major central banks in response to the dollar liquidity shortage is hopefully a precursor to future joint interventions that will raise market confidence. It is important that central banks around the world are able to maintain their independence and respond optimally to the crisis given their mandate. The recent pressures from political groups and governments on central banks serves no good purpose.

The other significant development in resolving the Euro area problems is the new emphasis on a fiscal union. The argument is that in the absence of rules like balanced budget requirements, fiscally mismanaged economies become a burden on other countries in the union. This is based on the assumption that the Euro area cannot credibly commit to not bailing out countries when they face the risk of default. For, if they could, the markets would hold each country independently accountable for repayment of their debt and countries like Greece would have to borrow at a premium over Germany.

The interest differential will put pressure on the mismanaged economy to address its fiscal issues. In other words, if the European Union can credibly commit not to bailout countries in distress, then the markets will automatically regulate the level of deficits they can sustain.

Given the recent response to the crisis, credibility has taken a huge hit and consequently the call for greater fiscal union. Regardless of where the debate on fiscal union settles, it should not be used as a pre-condition for addressing the current liquidity crisis. Altering the union treaty requires going down a long and uncertain path and the Euro currently does not have the luxury of time. The recent reference by German chancellor Angela Merkel that the solution to the current crisis will take the form of a 'marathon' is another misreading of the crisis.

Overall, I believe that there is still one last chance to save the Eurozone: One, there remains sufficient support among large swathes of the population in the Eurozone countries to make this work. Two, it is well understood that the costs of a collapse of the Euro will far exceed the Lehman crisis. Three, there are a 'few good men and women' in power to forcefully deal with the crisis and turn things around. But the clock is ticking…

(As told to Sujata Srinivasan)

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