FINANCIAL TIMES

May 27, 2012 8:59 pm

How to build a fiscal union to save the eurozone

88

By Wolfgang Münchau

We have reached bifurcation point – the time to make a decision. If Greece were forced to abandon the euro, the eurozone would mutate from a monetary union into a loose single currency area. I would then expect a mass withdrawal of foreign investment, a credit crunch and a large sustained fall in economic output. There is no way the eurozone will survive this shock in one piece. The consequences of a withdrawal would also be catastrophic for Greece.

A fiscal union lies in the other direction. But if it is to save the eurozone, it should comprise the following four elements. Not all have to be immediately introduced, but eurozone leaders should commit to them.

First, a eurozone-wide deposit insurance scheme with an unequivocal guarantee that deposits will be repaid in euros even if the host country leaves the eurozone.

Second, a eurozone-funded resolution trust company with the power to force a recapitalisation of the banks – without national veto. It is vital that this includes all banks, not just the biggest, as the most vulnerable happen to be the second-tier banks, such as Spain's Bankia. The trust needs to be accompanied by a further centralisation of bank regulation and supervision.

Third, a proper eurozone bond to cover a large portion of outstanding and new debt. It would require a partial transfer of fiscal sovereignty from the member state to the centre. Ideally, the new fiscal union should also have regulatory powers over labour and product markets.

Fourth, a change in the mandate of the European Central Bank to include specific responsibility for financial stability – and to make it explicit that the ECB faces no constraints on the conduct of secondary market operations in pursuit of its new mandate.

Points one and two would require legislation, but no change in the European treaties, and would need to be implemented right away. For points three and four it would be sufficient to state a firm intention now and initiate a treaty change process, which will take time.

At their dinner last Wednesday, European leaders may not have produced a resolution, but for the first time since the outbreak of the crisis, they have at least discussed actual measures of crisis resolution, including eurozone bonds and deposit insurance. On Wednesday night they paused to think. I consider that progress. The trouble is that they may have left it too late. It may not be possible to agree such a path in time, given the amount of opposition that has to be overcome.

What happens if Greece stays inside the eurozone, but the above list cannot be fully agreed?

In the first case, Greece would default into the rescue umbrella in 2013 or 2014. This year Spain will apply for a programme under the European Stability Mechanism to deal with the recapitalisation of its banking sector. That liability, too, will ultimately have to be shared. Since Italy is insolvent under current interest rates, it, too, would have to be brought into the ESM. But that would require an increase in its ceiling from a current €500bn to €2tn-€3tn. In the future, the liabilities of the ESM could be split into a bank resolution fund and into a eurozone bond. It would be an indirect and rather messy route, but would get us to the same outcome.

What if only a debt redemption bond is agreed? There seems to be some movement in that direction. One could think of a debt redemption bond as a eurobond for austerians. The idea, proposed by the German Council of Economic Advisers, is to pool all "excessive" debt into a eurobond and pay it back over 20 years. This is the portion of debt that is higher than the 60 per cent debt to gross domestic product ratio.

At the end of the 20 years, the bond would have been redeemed. Only national debt would be left.

I think the scheme is unrealistic because it the debt-to-GDP target itself is unrealistic. Do we really believe that Italy is going to reduce its debt-to-GDP ratio from 120 to 60 per cent? And it will not help Spain, since its problem is private sector debt. A redemption fund without proper eurozone bonds in the pipeline may also fail to produce a sufficient fall in interest rates. I would not advise the EU to adopt such an inadequate basis for a fiscal union.

This leaves us with the following choices: an immediate collapse if Greece leaves the eurozone; a direct resolution path to a fiscal union; an indirect path via an enlarged ESM; and a futile fudge.

My guess is that Europe's leaders will try the latter. This, too, will fail, at which point they will reach the next bifurcation point. I am, however, mildly encouraged by the sheer number of people in Brussels, Frankfurt, Paris and in Rome, who are now openly advocating a multi-stage fiscal union. There really is no alternative.