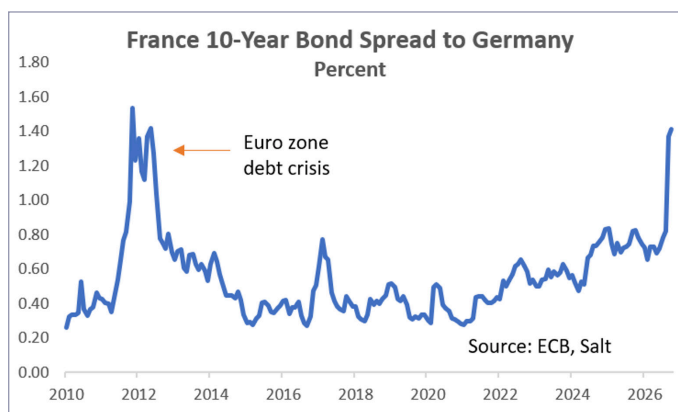


SALT INSIGHT

Europe's Unfinished Business

The widening spread between French and German government bond yields has brought back some uncomfortable memories of the eurozone sovereign debt crisis of 2011–12. But it has also revived a much more fundamental question that was never satisfactorily answered at the time: can a monetary union survive indefinitely without a meaningful degree of fiscal union?

I wrote extensively about this during the original crisis. My argument then was that the euro was a fundamentally fragile construct from the outset. Europe had created a common currency and central bank, but without the fiscal institutions or economic adjustment mechanisms necessary to support them. More than fifteen years after the crisis began, I remain unconvinced that the underlying problems have been resolved.



A monetary union without fiscal union

The fundamental weakness was straightforward. Member countries surrendered control of monetary policy and their exchange rates but retained responsibility for their

own fiscal affairs. They could no longer independently adjust interest rates in response to domestic economic conditions, yet there was no sufficiently powerful central fiscal authority capable of redistributing resources, sharing fiscal risks or providing meaningful support when individual economies encountered difficulties.

In other words, Europe had created monetary union without fiscal union. And when the sovereign debt crisis arrived, that structural weakness was brutally exposed.

The architects of the euro recognised the risks. The Maastricht Treaty, signed in 1992, established fiscal criteria limiting government budget deficits to 3% of GDP and government debt to 60% of GDP, or requiring debt ratios above that level to be declining sufficiently towards it. These rules were subsequently reinforced by the Stability and Growth Pact, intended to ensure fiscal discipline continued after countries joined the monetary union.

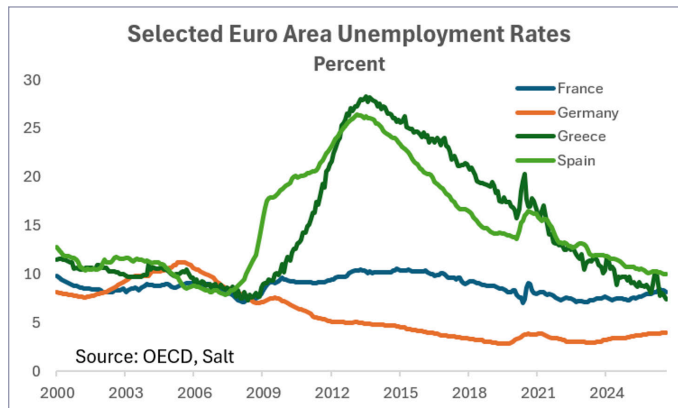
But fiscal rules are only as effective as their enforcement. Ironically, France and Germany themselves breached the deficit limits in the early 2000s, and the failure to enforce the rules against the eurozone's two largest economies seriously undermined the credibility of the framework. Europe had attempted to substitute fiscal rules for fiscal union but ultimately lacked the political will to enforce those rules consistently.

There was, however, another fundamental flaw in the euro's design. By adopting a common currency, member countries also surrendered the exchange rate as a mechanism for restoring competitiveness.

Before the euro, an economy experiencing a loss of

competitiveness could, at least in part, restore it through currency depreciation. Within the monetary union, that option disappeared. Instead, the adjustment had to occur through domestic wages, prices and employment.

Economists call this internal devaluation. But while exchange rates can adjust relatively quickly, wages and prices are notoriously slow to adjust downwards. Businesses are often more willing to reduce employment than cut wages. The consequence can be prolonged economic weakness and painfully high unemployment.



We saw exactly that during the sovereign debt crisis. Unemployment in Spain exceeded 26%, while in Greece it reached almost 28%. Those outcomes reflected a range of economic and financial problems, but the absence of exchange-rate flexibility made the adjustment considerably more difficult.

What might previously have been achieved partly through currency depreciation instead required a prolonged and socially costly adjustment in wages, employment and living standards.

The German advantage

There was also an inherent asymmetry in the arrangement.

Germany entered the euro with a highly competitive manufacturing sector and subsequently benefited from years of wage restraint and relatively subdued domestic demand. Its export competitiveness strengthened considerably relative to many of its eurozone partners.

Had Germany retained the Deutschemark, its strong export performance and persistent external surpluses would likely have put sustained upward pressure on its currency. Instead, Germany operated with an exchange rate reflecting the economic circumstances of the entire eurozone, including its less competitive members.

In effect, Germany enjoyed an exchange rate that was weaker than its own economic fundamentals would otherwise have justified, while less competitive economies were locked into an exchange rate that was effectively too strong for theirs.

Germany was therefore one of the principal beneficiaries of the euro's exchange-rate arrangements. Other countries benefited from lower borrowing costs, monetary stability and access to a larger integrated market. But the benefits were unevenly distributed, and much of the burden of restoring competitiveness fell on the weaker economies.

That was always going to create tensions within the monetary union.

Managing the crisis, rather than solving the problem

The European response to the sovereign debt crisis was an impressive exercise in crisis management.

Rescue mechanisms were established, banking supervision strengthened and, ultimately, the European Central Bank stepped in to reassure financial markets that the euro would survive. Mario Draghi's famous commitment to do "whatever it takes" proved a turning point.

Those measures were largely successful in containing the immediate crisis. The euro survived, financial markets stabilised and the risk of a disorderly break-up receded.

But managing the consequences of an incomplete monetary union is not the same as fixing its underlying design. The interventions bought governments time, but that time was not always used to put public finances on a sustainable footing. To a considerable extent, the can was simply kicked further down the road. And now the chickens are coming home to roost.

From the periphery to the core

The spread between French and German 10-year government bond yields has recently widened to levels last seen during the sovereign debt crisis.

France is confronting persistent budget deficits, a rising government debt burden and considerable political resistance to meaningful fiscal consolidation. With borrowing costs significantly higher than they were just a few years ago, the arithmetic of debt sustainability is becoming increasingly uncomfortable.

There is also an important difference between then and now. The original sovereign debt crisis was largely concentrated in Europe's periphery, particularly Greece, Portugal, Ireland and Spain. Today, the focus is shifting towards the very heart of Europe.

France is the eurozone's second-largest economy and one of the central pillars of the European project. Fiscal problems in the periphery were difficult enough to contain. Fiscal problems at the core present a potentially much bigger challenge.

Ironically, several countries at the centre of the original

crisis have subsequently made considerable progress in repairing their public finances. Meanwhile, France has moved in the opposite direction.

To be fair, Europe has not stood still. The European Stability Mechanism, banking union reforms and more recent common borrowing initiatives have made the eurozone more resilient than it was in 2011.

But Europe still lacks a permanent, sufficiently powerful central fiscal capacity or meaningful debt mutualisation. The political obstacles remain formidable, particularly the reluctance of fiscally stronger countries to assume responsibility for the debts of their neighbours.

That reluctance is understandable. Debt mutualisation without enforceable fiscal discipline risks encouraging governments to postpone difficult decisions. But the alternative is a monetary union in which individual countries remain vulnerable to sudden changes in investor confidence, without the full range of policy instruments available to sovereign nations.

Europe's unfinished business

None of this means another eurozone debt crisis is inevitable. The ECB has considerably more tools at its disposal than it did in 2011, and the institutional framework is stronger.

But there are limits to what central banks can achieve. They can provide liquidity and contain financial contagion. They cannot permanently resolve questions of fiscal solvency, restore lost competitiveness or substitute for difficult political decisions about taxation, spending and debt.

And that brings us back to the fundamental problem. The eurozone's original weakness was not simply that some governments borrowed too much. It was that the monetary union lacked adequate mechanisms for managing economic divergence between its members.

Fiscal imbalances were part of the problem, but so were differences in competitiveness, productivity performance and the absence of exchange-rate adjustment.

Greater fiscal integration could help share the burden of economic shocks, but even that would not eliminate the need for individual countries to maintain sustainable public finances and improve their competitiveness.

Ultimately, Europe's dilemma remains much the same as it was fifteen years ago. A common currency requires more than a common monetary policy. It requires either greater fiscal integration or a willingness by individual governments to maintain the fiscal discipline and economic flexibility necessary to make the existing structure work. Ideally, it requires both.

Europe has spent the past fifteen years strengthening the mechanisms designed to prevent another sovereign debt crisis, but the underlying fiscal challenges have never really gone away. And ultimately, bond markets have a habit of forcing the decisions politicians would rather avoid.

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