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Preventing the Next Euro-Zone Debt Crisis

by Michael Heise

Without a powerful "Finance Commissioner," it will be hard to restore confidence in the single currency.

The euro-zone agreement on potential support for Greece and other indebted member states last week ended a period of rising uncertainty about the euro's fate and Europe's coherence. The question now is whether the last-resort rescue plan will actually reassure markets that a default in the single currency zone is not on the cards.

The combination of contingent bilateral loans and IMF help offers seemingly solid support to Greece and others should assistance be required. But so far the impact on country-risk premiums, or credit spreads, has failed to materialize. Four days after the deal's announcement, new Greek 7-year bonds sold at a rate of 5.9% and the spread on 10-year bonds has actually widened further this week, suggesting that the markets are still not fully convinced that a debt rescheduling has been averted. After all, the support on offer will be conditional on the efforts made by the countries concerned to get a grip on their finances. If these are deemed inadequate, the veto granted to all member states could prevent the aid from flowing. Given the tortuous evolution of last week's deal, it cannot be ruled out that the markets will be tempted to test the euro zone's resolve.

But at least the agreement gives some breathing space both for Greece and other countries to get their financial houses in order and for the euro zone to revamp its rule book to prevent similar imbroglios in the future. For years now, the Stability and Growth Pact—which was supposed to enforce fiscal discipline—has been repeatedly breached without consequences. Enhanced coordination of European fiscal policies will be inevitable.

That does not mean, though, following the growing siren calls for a "European Monetary Fund." Putting money upfront to assist ailing euro-zone members would lead to a back-door bailout scheme, with built-in moral hazard. It's an old political law that whenever funds are available, they will be eventually used. In many countries, notably Germany, neither taxpayers nor the constitutional court would greet such a fund with enthusiasm.

What Europe needs instead is a mechanism that prevents fiscal crises in the first place. The primary goal of a revised Stability and Growth Pact must be to reduce euro-zone debt levels, which will approach 80% of GDP this year, way above the 60% limit. Even if countries manage to rein in annual deficits back below the 3% mark, debt levels would still continue to grow. That's why countries have to quickly return to balanced budgets, especially in the current environment of subdued growth and low inflation. This new zero-deficit target (adjusted for cyclical swings) is in fact already enshrined as a recommendation in the Stability and Growth pact, but has been blithely ignored. The euro zone needs a clearly defined deficit cap (as Germany adopted last year) with concrete spending rules that oblige member countries to balance their budgets under normal economic conditions by a certain year. This deadline could vary according to specific national conditions and capabilities. To achieve this, it would make sense to limit spending growth to at least two percentage points below nominal GDP growth, for example. Under conservative assumptions, that would enable a return to balanced budgets by 2016.

To make this work, the present deficit proceedings will have to be radically simplified and shortened. Countries that fail to comply with their budget or debt targets must face sanctions. Countries that outperform should be offered incentives. It makes no sense, though, to impose sanctions once disaster has already struck. The euro zone will need a new powerful "Finance Commissioner" whose office must have the right to demand amendments of medium-term budget plans before they lead to rising deficits. This new Commissioner must therefore have the authority to impose sanctions without interference from member states.

The creation of a position with powers on this scale may not be politically attractive as it touches on the financial sovereignty of member states. But without such sweeping changes, the euro zone will have a hard time restoring confidence in its finances and currency.

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