Blundering slowly to the wrong solution to the wrong problem
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The aim of the Euro was to preserve a policy environment of low inflation and low interest rates for which permanent credible exchange rate stability was seen as essential. These rules and strict formal rules on the operations of the ECB were designed to prevent crises, which were seen as coming only from fiscal laxity and provided for no remedies. In fact the result was the opposite of what the promoters intended. The Euro lowered interest rates and stimulated an unsustainable credit boom of private bank lending especially for property in Ireland Spain and Portugal.

The northern European countries that had, in the run up to the Euro, kept interest rates in line with German rates saw no change in interest rates but rates fell dramatically in the South and Ireland. The declarations in the Maastricht Treaty that member states of the Eurozone would not be bailed out was effectively dismissed as either irrelevant or non-credible. Noone worried that the European Central Bank had no official mandate to act as lender of last resort to banks, as is the responsibility of the Bank of England or the US Federal Reserve (the “Fed”).

The credit booms had two adverse effects on the affected economies. First the increased spending created inflation in these countries making them uncompetitive. Second the excess demand created by the booms sucked in imports and caused these countries to have balance of payments (trade) deficits.

Except for the Greek case there is no evidence at all that the current crisis was caused by excessive government borrowing before the crisis. Rather, if we look at the statistics we see the countries that got into trouble (bar Greece) did not have particularly poor public finance data before 2007, but they did have poor balance of payments positions.

In Greece the government evaded borrowing rules and borrowed amounts it thought it could repay if growth continued and interest rates stayed low; and this gamble might indeed have paid off. But in 2008 growth slowed and in 2010 creditors began to doubt first Greek then Spanish Portuguese and others’ ability to repay. Loss of confidence became a self-fulfilling vicious circle. Interest rates rose and the debt became more onerous. Most analysts believe that Spain and Italy have the potential to repay their current debt but that Greece does not. But the risk of a default at an unknown time and on an unknown scale poses a huge risk to the banks all over the world, (not unlike the sub-prime crisis of 2008).

The Italian case is rather peculiar. It did not have a particularly bad financial record but slow growth of national income meant that even a slowly rising public debt became a higher proportion of national income. Ireland is also peculiar in that it has cut wages very sharply and created an export surplus.

Being in the Eurozone meant the states in difficulty could not restore competitiveness by devaluation. Nor could they print money to support their home banks who had made such disastrous loans.

We are faced with at least 3 separate crises:
1. The short term Greek Crisis  
2. The medium term problems of Spain Italy etc  
3. The banking crisis  

The first one is due to excessive government debt. The second is due to slow growth and current account (trade) deficits. The third is due to the first two.  

Unfortunately the Eurozone (EZ) policy makers seem to be acting as if the entire crisis is due to excessive government borrowing, and that therefore cutting public spending is the solution. But if some very small countries (the Baltics and Ireland) can cut their own spending and sell surplus output, it does not follow that Spain and Italy and Portugal all can, when trading partners are cutting demand.  

The tight rules the EZ imposed on the European Central Bank and its member states make any corrective policy action other than “austerity” very difficult to adopt. But legal rules are being narrowly interpreted in very extreme ways. The ECB does already by government debt (but on the secondary market). The fundamental issue is not what the rules say but what makes economic sense and is politically sustainable. The Germans are proposing a Treaty change to force further austerity on the EZ: if this can be done so can a rule-change confirming the right of the ECB to buy bonds or lend to the European Financial Stability Fund.  

There are those who believe that austerity can force through more labour market flexibility and wage cuts and that this will allow the deficit countries to become more competitive, even if there is no easing of credit and even if Germany takes no action to expand demand. But there is probably a balance of opinion the other way: George Soros, the German Council of Economic Advisers, and the DIW Institute in Berlin are all calling for the equivalent of a bond buying programme linked to the ECB to buy distressed debt. A credible promise to do this might be enough, though more delays would mean more action would be needed to show credible willingness. The financial markets actually do seem to be anticipating some sort of support. But the time of writing we don’t know what will happen next. It is to be hoped that Mrs Merkel will go to her conservative MPs and say: “Sorry guys I did my best - there is no alternative to letting the ECB lend money”. But it risks another disaster down the road if the price of this were to be politically, economically and socially unsustainable austerity requirements that would bring the crowds out on the streets and the Southern member states out of the Euro, and risk the whole EU system collapsing.