The ‘grand bargain’ is just a start

By Martin Wolf

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Will the eurozone survive its **crisis**? That was the question I raised **three weeks ago**. My answer was: yes. My argument was that economic self-interest and political will would combine to preserve the common currency, in spite of the difficulties.

Yet that raises a further question: have leaders now done enough to put the eurozone on a sound footing? The answer is: no. Progress has indeed been made. But more will be needed, both intellectually and institutionally. Evidently, I am assuming that further shocks will compel further reforms. That is my judgment. It cannot be a certainty.

The euro is a unique project. For sovereign states to share a currency demands solidarity and discipline. The more diverse are the component economies and the more divergent is their performance, the greater is the need for solidarity and the smaller is its likely supply. So it has proved. I was one of the many who believed that a stronger political union and greater economic flexibility would be needed if the eurozone was to survive in the long run. Only in a crisis would it become clear whether the conditions for survival would be met. This crisis provides the test.

A fascinating **speech** by Lorenzo Bini Smaghi, a member of the executive board of the European Central Bank, makes the point. “Europe”, notes Mr Bini Smaghi, “is evolving, growing, continuing on its path of integration. This is not happening, however, according to some pre-defined, agreed plan, but rather in response to the challenges it faces, which in some cases are likely to endanger the very existence of the Union.” The current crisis is such a challenge. This might be called “the perils of Pauline” route to integration. It is hugely risky, but it has also worked, at least so far.

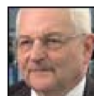
The response to the crisis is a superb example of the risks and rewards of this approach. The shock caught Europe unawares. Some had recognised the dangers created by huge internal imbalances and irresponsible lending to peripheral countries. Few realised this might interact with a global financial disaster to generate banking, sovereign debt and competitiveness crises inside the eurozone.

In response, leaders have innovated spectacularly. Within a year, they have approved a €110bn ($155bn) rescue package for Greece, in co-operation with the International Monetary Fund, endowed a new European financial stability facility with €440bn, decided to amend the treaty, to create a permanent rescue mechanism, amended the stability and growth pact, to enhance fiscal discipline, and created a new system of macroeconomic surveillance.

Germany has accepted ideas that its citizens abhor. Countries in difficulty have accepted austerity that their citizens abhor. We have seen much kicking and heard much screaming. But the show goes on.

Yet however far the eurozone may have come, it has not yet come far enough. There are three challenges.

Martin Wolf’s Exchange

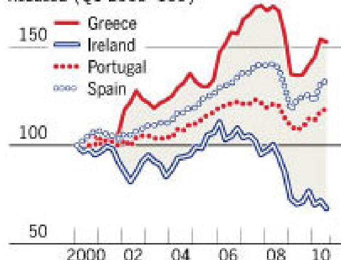


Martin Wolf elicits readers’ views on current economic issues

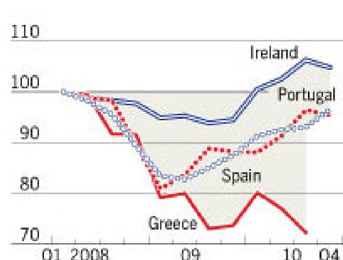
First, the leaders have not created a regime capable of preventing and dealing with the potential crises.

True, important areas of **agreement** have been reached. One is the intention to monitor and promote competitiveness, particularly in labour markets. Without flexible labour markets, such a currency cannot work. Another is the focus on long-term fiscal sustainability. Yet another is the decision to legislate for banking resolution. Another is the plan to monitor debt of banks, households and non-financial companies. Nevertheless, big holes remain. The most important hole in the plans for economic co-ordination is the unwillingness to recognise the link between the external surpluses of core countries and the financial fragility in the periphery. The focus remains overwhelmingly on fiscal indiscipline, which was not the cause of the crises in Ireland or Spain.

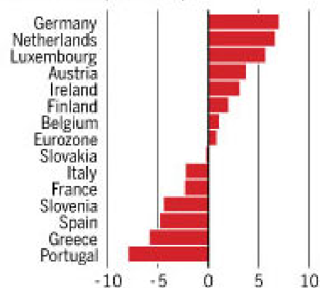
Unit labour costs in manufacturing relative to Germany
Rebased (Q1 2000=100)



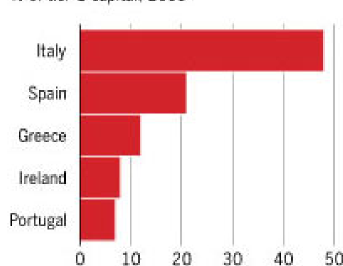
Export volumes
Rebased (Q1 2008=100)



Current account balances
2012 forecasts (% of GDP)



German banks' exposure to public debt
% of tier 1 capital, 2009



Sources: Thomson Reuters Datastream; OECD Economic Outlook; Nomura

Meanwhile, the biggest failing in the plan for a permanent European stability mechanism is that its resources – a total of €500bn – would be insufficient to manage liquidity crises in larger countries. Moreover, as my colleague **Wolfgang Münchau has also noted**, even this depends on resources from countries that may themselves need to be rescued.

Second, it is unclear whether the countries now in difficulty will be able to escape from their crises at manageable political cost. They have barely begun what is surely going to prove a long and painful process of adjustment. At present, Greece, Ireland and Portugal find access to financial markets prohibitively expensive. It is unclear when or how they can regain it. Yet they have no easy alternative to the slog. The countries in difficulty have large structural primary fiscal deficits (that is, before interest payments). Thus, debt restructuring alone is no panacea. An additional question is whether those in trouble can regain competitiveness without making their euro-denominated debt yet more unmanageable. At present, the countries likely to adjust their way out of the mess seem to be Ireland and Spain. But further political and economic shocks are all too likely.

Third, the eurozone has failed to cut the Gordian knot connecting the fiscal to the financial crises. Today's dominant opinion is that the senior creditors of banks must be made whole, while governments must avoid restructuring their debts. This combination is a machine for loading the costs of past bad lending onto the taxpayers of countries whose private sectors borrowed excessively.

This is, alas, a "transfer union". But those transfers occurred years ago, when these loans were made. It would be helpful – and honest – for the German government and the governments of other creditor countries to tell their people that they are rescuing their own savings in the guise of rescuing peripheral countries. The alternative is to write off loans and recapitalise their banks directly. To admit this would be to admit their policies have been at fault. That would surely be helpful.

Indeed, we can go further. An admission that mistakes have been made by both the virtuous and the sinners may be a necessary condition for sustaining the political will to strengthen the system. Huge challenges remain ahead. It would be easier to believe they will be overcome if everybody confessed to their part in the mess. Those who lent so foolishly and those who borrowed so foolishly are implicated.

As Christine Lagarde, the French finance minister, has **remarked**, **"it takes two to tango"**. So it does. The eurozone's tango is fiendishly complicated. But the dance goes on. It will continue to do so, provided the will to remain entwined survives.

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