The Maginot Line

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Three years ago, on September 15, 2008, Lehman Brothers filed for bankruptcy and threw the global financial system into a period of instability from which it has yet to recover. The fact that the three year anniversary of Lehman's collapse was marked by an announcement by the world's central banks that they are extending unlimited support to European banks is clear evidence that the crisis has not passed. It is normally the case that dramatic actions by economic authorities signal that a crisis is worsening, not that it is going to be solved. The central banks are drawing a Maginot Line against further economic stability. Their action may appear bold and effective on the surface, but in the end their efforts are bound to prove ineffective if not accompanied by dramatic fiscal reform by the individual members of the EU.

Readers need to understand three key points with respect to the European sovereign debt crisis. First, it will not be solved by the September 15 announcement that the ECB will team with the U.S. Federal Reserve, the Swiss National Bank, and the Bank of Japan to insure dollar liquidity to European banks. This is more monetary medicine for a fiscal disease. Second, this crisis poses an ongoing risk to the global financial system and requires drastic fiscal remedies rather than the drastic yet traditional monetary fixed being put into place by European authorities. Finally, this may be called a debt crisis but it is really a currency crisis. Requiring countries with vastly different economies and cultures to adopt a single currency is an exercise in futility or, put another way, bound to cause the types of problems certain countries are experiencing. A true European union is not achievable without drastic changes in the Maastricht Treaty and the flawed economic model that it enforces.

As the United States has learned to its dismay, fiscal problems cannot be solved by central banks bearing monetary weapons. In order to return countries to fiscal balance and stability, only fiscal measures can be expected to succeed. After three years of near-zero interest rates, the U.S. is still experiencing a deep housing crisis and a distressing jobs crisis. Monetary medicine has not worked because it is not equipped to heal a fiscal disease. The absence of fiscal reform in the areas of budgeting, taxation, regulation and related policies has made it impossible for the U.S. to address the problems that are retarding economic growth. (The good news about the U.S. is that its large banks are well capitalized and extremely liquid three years after Lehman's bankruptcy. The banking crisis appears - at least for the moment – to be confined to Europe.)

Europe has been following the same misguided policy path as the United States with the extra burden of having to comply with the Maastricht Treaty. At this point the Maastricht Treaty is only being honored in the breach because certain members of the European Union are simply incapable of meeting its requirements. A treaty that is violated on a daily basis quickly loses legitimacy, if not among political leaders than certainly among the citizenry. On one side sit those whose countries cannot meet its requirements, such as the Greeks. On the other side sit those whose countries can meet the requirements, such as the Germans. The Greeks don't understand why they are being forced to suffer such severe economic distress, and the Germans are asking why they are the ones paying for Greece's economic failures. To quote the great Irish poet William Butler Yeats: "The center cannot hold."

Greece may only represent 3% of the European economy, but the interconnected nature of financial markets renders it a genuine threat to global financial stability. In early September, the infection of German and French banks with holdings of distressed Greek sovereign debt ignited the crisis of confidence in the European banking system that the central banks' September 15 commitment is intended to salve. While most European banks were claiming they had sufficient liquidity, two banks came to the European Central Bank for€ 410 billion of funding earlier this week, presumably due to difficulties in funding themselves in the markets. A day before that, Moody's Investors Service downgraded Credit Agricole and Societe Generale due largely to their exposure to Greek debt. Europe is experiencing a repeat of the 2008 financial crisis, which was centered on the banking systems of Europe and the U.S. and was a crisis of both solvency and liquidity.

The September 15 central bank announcement is definitive proof that the crisis is systemic and requires a systemic solution. Unfortunately, the central banks are not offering the type of long-term systemic solution required (although the announcement should momentarily calm financial markets). This is the first coordinated effort to address the current phase of the European debt crisis, which suggests that economic leaders on both sides of the Atlantic understand the threat that the crisis poses to systemic stability. While many investors were caught short with this announcement, they should not be fooled into believing that this announcement will solve the crisis. In fact, it is another example of applying monetary policy to fiscal infirmities.

Monsieur Sarkozy and Frau Merkel are making promises that they cannot keep. There is every indication that the German people are unalterably opposed to open-ended support for their southern neighbors, whom they view as profligate and fiscally irresponsible. Frau Merkel's support of Greece in the face of the overwhelming opposition of her constituents bodes poorly not only for her own electoral prospects but for the future of the EU itself. For if Germany no longer supports the European project, that project will not survive in its current form. European leaders remain in denial. The time to triage Greece has come. Greece's relatively small economy belies its importance in the global economy. Greece will pull the union into deeper waters than those in which it can swim. Greece is a black hole of liabilities, and it is not reasonable to expect any member of the EU, even the wealthiest, to keep dumping money into a black hole. The Greeks are not going to change without a crisis far more severe than the economic depression they are experiencing today. Greeks will continue to avoid paying taxes and demonstrating a greater aptitude for leisure rather than work until the pain of such preferences becomes unbearable. That can only occur when Greece is forced to pay its own debts rather than have its northern neighbors pick up the bill.

The final point to be understood is that Greece's situation is definitive proof that the European debt crisis is really a currency crisis. Certain countries – Greece, Portugal and even Spain and Italy –

struggle to compete in the thrall of the Euro. I have noted in ***El Mundo*** and elsewhere that Iceland provides the proper example for dealing with this crisis. Iceland defaulted on its debts, rejected the Euro, readopted its own currency and devalued it sharply, and then suffered through three extraordinarily difficult years of economic pain. But three years after defaulting, Iceland was able to borrow again in the public markets (and borrow 5-year paper at a low 3% interest rate) and return its economy to stability. Greece, married to the Euro, has seen its borrowing rates skyrocket to the extent that the country cannot raise money anymore. Until Greece is considered competitive and capable of meeting its obligations, it will be denied access to global financial markets. Countries being suffocated by the Euro, such as Greece, should follow the same path. And the rest of Europe should allow them to do so before the threat that their economic impotence is posing to the EU turns into full-blown global financial crisis.

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