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Eurozone Crisis: Will Reforms be Enough?

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Synopsis

The Economic and Monetary Union launched in Europe in 1999, was an experiment amongst countries with diverse economic structures. A number of reforms have since been initiated to address the flaws in its design. Will these reforms be enough to save the euro?

Commentary

GIVEN THE raft of gloomy economic data from the region, it is hardly appropriate to be optimistic about the prospects for the sustainability of the monetary union in Europe. But in one key area some progress is being made. The root causes of the crisis have been identified and actions are being taken to address them. This week, on 12 September 2012, a little known German constitutional court took a huge decision and cleared the country's participation in a new bailout fund. Markets have reacted positively. Also the win of the pro-EU party in the Netherlands is encouraging. A week prior to this, the European Central bank (ECB) reversed an earlier decision and announced that it would serve as a lender of last resort for government bonds.

Root causes of the crisis and flaws

The root causes of the eurozone crisis were the flaws in the design of the monetary union. The Economic and Monetary Union (EMU) launched in 1999 comprised the euro (the single currency) and the European Central Bank (ECB) for a common monetary policy. It did not contain a fiscal union, and other institutional mechanisms required for coordinating structural policies. Both the Werner Report of the 1970s and the Delors' Report of the 1980s, which served as the blueprint, had developed a three-stage roadmap comprising closer economic coordination among members, binding constraints on member states' national budget, and a single currency.

But in their haste and eagerness to accomplish a full and irrevocable European unity, the "founding members" had felt that the two convergence criteria enshrined in the Maastricht Treaty – a three per cent limit on annual fiscal deficit and 60 per cent limit on gross public debt to GDP ratio - would be adequate for the purpose.

In practice, these thresholds were neither binding nor fixed. The EMU was, therefore, launched as an experiment between a set of countries that were quite diverse and far less integrated than required. And the hope that a monetary union would lead to an economic union was not realised.

The institutional flaws have now been identified and are being fixed. A key shortcoming in the design of the

EMU was the absence of the lender of last resort in government bond markets. When a country issues sovereign bonds in its own currency there is an implicit guarantee from the central bank that cash will always be available to pay out the bondholders. The absence of such a guarantee in a monetary union – where bonds are issued in a currency over which individual countries have little control - makes the sovereign bond markets prone to liquidity crisis and contagion, very much like banking systems in the absence of lender of last resorts.

ECB as lender of last resort

Initially, given the no-bailout clause in the EU treaty, the ECB was reluctant to pursue the role of lender of last resort. Instead, the eurozone set up the European Financial Stability Facility (EFSF) for the purpose. A permanent 500 billion euro European Stability Mechanism (ESM) is targeted by the year-end and this week's German constitutional court approval was a key step forward. The establishment of the ESM is critical as the EFSF is running out of money (having bailed out Greece, Ireland, and Portugal) and is due to expire in less than a year.

But there has been a dramatic turnaround in the ECB. In July, ECB chief Mario Draghi, had promised to “do whatever it takes” to protect the euro. He delivered on 6 September when he announced plans to make the ECB the lender of last resort in government bond markets. Under the new programme dubbed the Outright Monetary Transactions (OMT), the ECB will buy existing government bonds in the secondary market without limits. The OMT will primarily benefit fiscally-troubled countries like Spain and Italy which are facing difficulties financing their debt as their borrowing costs have soared in recent months.

To prevent moral hazard and ensure that countries continue their austerity programmes, the ECB will require that a country seeking to benefit from the OMT to first apply to the eurozone's bailout fund, the EFSF and the ESM, which require tough conditions. The ECB will also continue to offset its purchases in full by taking an equal amount of liquidity out of circulation so that money supply will not change.

Fiscal Compact for crisis prevention

In the area of crisis prevention several bold actions are being taken. Firstly, in March 2012, EU members (except the Czech Republic and the United Kingdom) agreed to set up a new Fiscal Compact. The Compact will require all ratifying members to enact laws on national budgets to meet the two Maastricht convergence criteria except that this time around implementing it will be enforced by the European Court of Justice. The target is to make the Compact effective on 1 January 2013 if it is ratified by at least 12 members.

Secondly, a banking union is also being established. This requires establishing a Europe-wide supervisor – Brussels has proposed ECB for the task. It also requires setting up a deposit guarantee scheme, and a resolution regime to ensure that unsecured creditors rather than taxpayers pay the cost of future bank failures.

A number of actions are being taken to refocus the experiment that the “founding fathers” of the EMU began in 1999. These, however, fall short of a full-fledged fiscal union with taxes and expenditure handled by a common authority, deeper integration including with high labour mobility, and a political union such as the “United States of Europe”. This is because each of them requires politicians to give up powers which many of them regard as sacrosanct. Whether the reformed EMU, or EMU II, will be enough to save the single currency system remains to be seen.

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