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An effective policy response to Europe's debt crisis

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As the European debt crisis intensifies, internal opposition has stalled plans to purchase government bonds as an emergency measure and to issue eurobonds that would strengthen Europe's monetary union. To break through its current policy impasse, the eurozone needs a framework that effectively strengthens fiscal discipline. Such a framework would mitigate the risk of moral hazard associated with eurobond issuance and the risk of indefinite expansion of government bond purchases.

Eurobonds would strengthen monetary union

Amid widespread media speculation on the demise of the euro, policy measures to strengthen eurozone integration appear to finally be moving forward in the wake of a Franco-German-Italian summit held in late November.

While the eurozone has a unified monetary policy and exchange rate, it is subject to major restrictions on redistribution of income through fiscal transfers to rectify macroeconomic imbalances among countries. An agreement reached at a July 2011 EU summit has spawned hopes that the European Financial Stability Facility (EFSF) will fulfill a de facto fiscal transfer function by providing financial assistance to distressed countries, using funds borrowed from the market pursuant to debt guarantees by major EU countries. The European Commission recently proposed options for eurobonds and encouraged EU countries to study them in detail. The EC's proposal can be construed as another step toward making fiscal transfers feasible.

Germany, however, has expressed strong alarm at such plans for several reasons. First, if the EU were to merely unify bond issuance by eurozone countries, the de facto debt guarantees on fiscally distressed countries' sovereign debt would impose a heavy burden on the guarantor countries, including Germany. Second, given recent rating actions by rating agencies, the risk that Germany would end up as the sole guarantor cannot be ruled out. Third, Germany is worried that the market would demand higher interest rates on eurobonds than on German *bunds*.

Germany's concerns are rational. As such, they seem to be an insurmountable obstacle to eurobond issuance.

Government bond purchases as an emergency measure

With market yields on overindebted European countries' bonds recently rising sharply, these countries' ability to refinance their debt as needed and ultimately meet their interest and principal obligations is being called into question. In other words, their solvency is in doubt. Meanwhile, the financial system is plagued by similar concerns because European financial institutions hold large quantities of questionable sovereign debt. It remains to be seen whether the financial system can avoid severe instability triggered by eruption or contagion of sovereign risk.

One emergency measure to prevent these risks from manifesting is government bond purchases by public authorities. If the authorities purchase fiscally distressed countries' bonds to some extent, the purchases would help resolve the crisis by enabling the countries to stably roll over their maturing debt and reducing their interest expense despite upward pressure on market interest rates. The purchases would thereby contribute to allaying anxieties about troubled countries' solvency and, in turn, alleviating upward pressure on market interest rates. If able to reduce the financial system's sovereign risk, the bond purchases would simultaneously enhance systemic stability. Of course, recapitalizing financial institutions would likewise contribute to systemic stability, but the financial system would still not be able to escape from the risk of secondary losses unless its sovereign risk is reduced.

Although government bond purchases by the EFSF have already been approved in principle by eurozone countries' legislatures, the specifics of the bond purchasing operations have yet to be determined. Consequently, the European Central Bank's Securities Market Programme (SMP) has essentially been fulfilling the EFSF's role. Moreover, some market participants and European politicians are loudly calling for even larger-scale government bond purchases.

The ECB has strongly resisted such pressure to expand its SMP. Aside from the legal issue of whether the SMP violates the EU's prohibition against fiscal financing by the ECB, the ECB's opposition presumably reflects strong concerns that its government bond purchases could end up undermining confidence in the euro. In the European debt crisis's initial stage, when government bond purchases were limited to Greek bonds, the ECB's opposition perhaps could have been dismissed as unfounded. However, now that funding difficulties have spread from Portugal and Ireland to countries with large government bond markets such as Spain and Italy and stress is evident even in the French and German bond markets, the ECB's argument against purchasing government bonds has ironically become quite persuasive.

Long awaited policy response

To break through its short- and longer-term policy impasse, the eurozone must come up with an effective framework for strengthening fiscal discipline.

The eurozone has a Stability and Growth Pact (SGP) to prevent the chronic fiscal deficits and resultant excessive growth in government debt that are at the heart of Europe's current crisis. However, the SGP has become largely meaningless, with even major EU countries failing to comply with it. The eurozone should promote fiscal discipline among its constituent countries through adequate governance (e.g., reciprocal monitoring of SGP compliance among countries, harsher penalties for noncompliance). Doing so would not only reduce the cost of fiscal transfers for macroeconomic convergence of eurozone countries, it would also reduce the risk of moral hazard among overindebted countries. Such an outcome should make Germany more amenable to rethinking its strong opposition to eurobond issuance.

Another likely outcome is more flexible cooperation from the ECB. The ECB regards its SMP as a temporary and tactical policy response, as emphasized by ECB President Mario Draghi at a recent press conference. Rather than rejecting government bond purchases outright, the ECB seems to be strongly concerned about their disorderly expansion and/or indefinite continuation. An effective framework for strengthening fiscal discipline would mitigate the risks about which the ECB is concerned.

Those skeptical of the euro's prospects for survival may doubt that a framework to strengthen and maintain fiscal discipline in the eurozone can be realized within a few months, given that fiscal discipline has proved elusive for the past decade. Moreover, with Italian and Spanish government bond yields now in the vicinity of 7% and funding strains emerging in short-term money markets, policy measures do not have much of a grace period to prove their effectiveness. Conversely, however, because the situation is so urgent, financial market forces in the form of a financial crisis could ultimately be the impetus that leads to a policy solution, though such a scenario would entail hardship for the countries involved.

By the time this article is published in early 2012, I sincerely hope that policies to enhance monetary union and resolve Europe's debt crisis are taking concrete shape by virtue of stronger fiscal discipline among European countries.

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