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Delaying the Next Global Meltdown

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In our last one-pager we outlined the reasons why it is a mistake to interpret the unfolding disaster in Europe as primarily a "sovereign debt crisis." The underlying problem is not periphery profligacy, but rather the very setup of the European Monetary Union (EMU)—a setup that even now prevents a satisfactory resolution to this crisis. The central weakness of the EMU is that it separates nations from their currencies without providing them with adequate overarching fiscal or monetary policy structures. Put differently, the EMU is like a United States without a Treasury or a fully functioning Federal Reserve. The latest plan for the eurozone, a new "fiscal compact" featuring a stricter version of the Stability and Growth Pact's budget limits, represents nothing but a doubling down on this same flawed architecture. Without addressing this basic structural weakness, Euroland will continue to stumble toward the cliff, and threaten to pull a tottering US financial system over the edge with it.

If an embattled country like Greece were to leave the EMU and revert to its own currency, it would gain the fiscal and monetary policy space needed to deal with its crisis, but such an exit would leave huge costs in its wake. The question is whether adequate policy space can be created while keeping the currency union intact. The only solution is to reconstitute the EMU.

Eurozone member-nations are users of an external currency, much like US states. But unlike those states, eurozone members cannot rely on a body with the spending power of a US Treasury. While Washington commands a budget that is greater than 20 percent of GDP, and usually runs a budget deficit that is several percent of GDP, the European Parliament's budget is less than 1 percent of GDP. Providing the eurozone with sufficient fiscal policy space to kick-start adequate economic growth requires ramping up the Parliament's budget to 15 percent of GDP, with a capacity to issue debt. Spending decisions could be centralized, or funds could simply be transferred to individual states on a per capita basis.

Countries with very different economies are yoked to the euro. Nations like Greece are not positioned to compete with countries that are more productive, like Germany, or that have lower production costs, like Latvia. Any workable plan to save the euro has to address those differences. "Refluxing" the current account surpluses of countries such as Germany, France, and the Netherlands into deficit countries by, for example, investing euros in them, would even out trade imbalances—much as Germany did with the former East Germany following reunification. For the eurozone, this could be accomplished by expanding the role and funding of the European Financial Stability Facility (EFSF). A revamped EFSF, which should be made responsible to the European Parliament, could approximate the US Treasury's relationship to the American states.

Finally, to address solvency issues the EMU needs a buyer of last resort for eurozone government bonds. European Central Bank (ECB) rules could be changed to allow the bank to buy government debt issued by EMU members, up to an amount equal to 6 percent of Euroland GDP each year. The allocation would be on a per capita basis across the member-states, and individual members could continue to issue bonds to markets, allowing them to exceed the debt issue bought by the ECB (much as US states issue bonds). One can conceive of variations on this theme, but what is essential is that the backing comes from the center: the ECB or the EU stands behind the debt. This will help avoid the vicious debt cycles that can result from exploding interest rates.

A collapse of the EMU would derail the feeble US recovery and send its financial system reeling. US financial exposure to Europe is something on the order of $3 trillion, half of which is due to investments in European banks by US money market mutual funds. Given that many US financial institutions are already insolvent, this kind of hit could send the system over the brink.

Even without a eurozone collapse, the US financial system is poised for disaster. Shoring up that system and reinvigorating our real economy are essential no matter what happens in Euroland. First, insolvent US banks must be resolved. As we know, the costs of eventual resolution multiply when insolvent banks are kept open by a policy of "extend and pretend." Closing up and reforming the largest insolvent banks would lead to a stronger financial system, with smaller institutions and less concentrated economic power. Second, debt relief for homeowners is essential. Writing down mortgages must be done for everyone, not just for those who default. The federal government, working with government-sponsored enterprises or private lenders, could provide new mortgages on favorable terms (fixed rate, 30 years), which would be used to retire outstanding mortgages. Policy must determine how losses (the difference between the new mortgage and the outstanding mortgage) would be shared among the mortgage originator, servicer, security holder, and government. Finally, we need to add more than 20 million full-time jobs to the economy. The federal government will have to fund a significant portion of these, through a combination of jobs programs and block grants to states for infrastructure and social care work.

A further discussion of this topic can be found at www.levyinstitute.org/pubs/op_20.pdf.

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