

# The European Union's Tragedy of Policy Errors

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It is now clear that the main cause of the euro crisis is the member states' surrender of their right to print money to the European Central Bank. They did not understand just what that surrender entailed — and neither did the European authorities.

When the euro was introduced, regulators allowed banks to buy unlimited amounts of government bonds without setting aside any equity capital, and the European Central Bank discounted all euro-zone government bonds on equal terms. Commercial banks found it advantageous to accumulate weaker countries' bonds to earn a few extra basis points, which caused interest rates to converge across the euro zone. Germany, struggling with the burdens of reunification, undertook structural reforms and became more competitive. Other countries enjoyed housing and consumption booms on the back of cheap credit, making them less competitive.

Then came the crash of 2008. Governments had to bail out their banks. Some of them found

themselves in the position of a developing country that had become heavily indebted in a currency that it did not control. Reflecting the divergence in economic performance, Europe became divided into creditor and debtor countries.

When financial markets discovered that supposedly riskless government bonds might be forced into default, they raised risk premiums dramatically. This rendered commercial banks potentially insolvent, because their balance sheets were loaded with such bonds. This in turn gave rise to Europe's twin sovereign-debt and banking crisis.

The euro zone is now replicating how the global financial system dealt with such crises in 1982 and again in 1997. In both cases, the international authorities inflicted hardship on the periphery to protect the center. Now Germany is unknowingly playing the same role.

The details differ, but the idea is the same: Creditors are shifting the entire burden of adjustment onto debtors, while the "center" avoids its own responsibility for the imbalances. Interestingly, the terms "center" and "periphery" have crept into usage almost unnoticed. Yet in the euro crisis, the center's responsibility is even greater than it was in 1982 or 1997; it designed a flawed currency system and failed to correct the defects. In the 1980s, Latin America suffered a lost decade, and a similar fate now awaits Europe.

At the onset of the crisis, a breakup of the euro was inconceivable. The assets and liabilities denominated in a common currency were so intermingled that a breakup would have led to an uncontrollable meltdown. But as the crisis has progressed, the financial system has become increasingly reordered along national lines. This trend has gathered momentum in recent months. The European Central Bank's long-term refinancing operation enabled Spanish and Italian banks to buy their own countries' bonds and earn a large spread. Simultaneously, banks gave preference to shedding assets outside their national borders, and risk managers try to match assets and liabilities at home rather than within the euro zone as a whole.

If this continued for a few years, a euro breakup would become possible without a meltdown, but it would leave the creditor countries with large claims against debtor countries, which would be difficult to collect. In addition to intergovernmental transfers and guarantees, the Bundesbank's claims against peripheral countries' central banks within the Target2 clearing system totaled 644 billion euros (\$804 billion) on April 30, and the amount is growing exponentially, owing to capital flight.

So the crisis keeps growing. Tensions in financial markets have hit new highs. Most telling is that Britain, which retained control of its currency, enjoys the lowest yields in its history, while the risk premium on Spanish bonds is at a new high.

The real economy of the euro zone is declining, while Germany is booming. This means that the divergence is widening. The political and social dynamics are also working toward disintegration. Public opinion, as expressed in recent election results, is increasingly opposed to austerity, and this trend is likely to continue until the policy is reversed. Something has to give.

In my judgment, the authorities have a three-month window during which they could still correct their mistakes and reverse current trends. That would require some extraordinary policy measures to return conditions closer to normal, and they must conform to existing

treaties, which could then be revised in a calmer atmosphere to prevent recurrence of imbalances.

It is difficult, but not impossible, to identify some extraordinary measures that would meet these tough requirements. They would have to tackle the banking and the sovereign-debt problems simultaneously without neglecting to reduce divergences in competitiveness.

The euro zone needs a banking union: a European deposit-insurance scheme to stem capital flight, a European source for financing bank recapitalization and supervision and regulation across the euro zone. The heavily indebted countries need relief on their financing costs. There are various ways to provide it, but they all require Germany's active support.

That is where the blockage is. German authorities are working feverishly to come up with a set of proposals in time for the European Union summit Thursday and Friday, but all signs suggest that they will offer only the minimum on which the various parties can agree, implying, once again, only temporary relief.

But we are at an inflection point. The Greek crisis is liable to come to a climax in the fall, even if the election produces a government that is willing to abide by Greece's current agreement with its creditors. By that time, the German economy will also be weakening, so Chancellor Angela Merkel will find it even more difficult than today to persuade the German public to accept additional European responsibilities.

Barring an accident like the Lehman Brothers bankruptcy, Germany is likely to do enough to hold the euro together, but the EU will become something very different from the open society that once fired people's imagination. The division between debtor and creditor countries will become permanent, with Germany dominating and the periphery becoming a depressed hinterland.

This will inevitably arouse suspicion about Germany's role in Europe, but any comparison with Germany's past is quite inappropriate. The current situation is due not to a deliberate plan but to the lack of one. It is a tragedy of policy errors. Germany is a well-functioning democracy with an overwhelming majority for an open society. When the German people become aware of the consequences and let's hopes it doesn't come too late they will want to correct the defects in the euro's design.

It is clear what is needed: a European fiscal authority that is able and willing to reduce the debt burden of the periphery, as well as a banking union. Debt relief could take various forms other than eurobonds and would be conditional on debtors' adherence to the fiscal compact. Withdrawal of all or part of the relief in case of nonperformance would be a powerful protection against moral hazard. It is up to Germany to live up to the leadership responsibilities thrust upon it by its own success.

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