CEPS COMMENTARY
Thinking ahead for Europe

Who cares about the survival of the eurozone?

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The prevailing wisdom in Europe today argues that a necessary and sufficient condition to stop the eurozone government debt crisis is budgetary austerity. We have been told that if the countries of the periphery (and soon less peripheral countries like Belgium and France) apply painful austerity programmes, financial markets will gain confidence again and the debt crisis can be stopped. We hear this prescription both in Brussels and in Frankfurt. Thus, in Brussels, the European Commission is actively engaged in forcing national governments to implement tougher austerity programmes, threatening to impose automatic sanctions if austerity is loosened. But, so we are told, if we apply this heavy medicine, reward is forthcoming because financial markets will be confident again. This confidence will then pay off with lower interest rates and a return to economic growth.

In Frankfurt, the same story is told by the European Central Bank: only austerity will solve the debt crisis. Thus the solution lies squarely in the hands of politicians. The ECB has nothing to do with it, and it would certainly be wrong for this guardian of price stability to be a lender of last resort.

It is now becoming increasingly clear that generalised austerity in the eurozone will not pacify the financial markets. On the contrary, the increasing intensity with which budgetary austerity is applied will make the financial markets less rather than more confident that the sovereign debt crisis can be overcome. The reason is very simple, as is being increasingly recognised. When all eurozone countries are forced to accept austerity at the same time, deflationary forces are set in motion that lower output and government revenues throughout the eurozone. As a result, government budget deficits do not decline sufficiently to prevent the debt-to-GDP ratios from increasing, as the denominator in these ratios (GDP) goes down faster than the numerator (the debt level). Thus, the effect of generalised austerity is recession and more unsustainable levels of government debt. Generalised austerity undermines the confidence of financial markets, because it leads the eurozone straight into a recession.

This scenario does not seem to dissuade the Brussels-Frankfurt contingent from their conviction that even more austerity should be applied. The fact that budget deficits do not decline is seen by European policy-makers as evidence that not enough austerity is being applied – not that generalised austerity does not work.

The European Commission and the ECB continue to mistakenly believe that austerity will increase confidence and in so doing will stimulate economic activity. There is precious little evidence in support of this theory, yet policy-makers have not been deterred from persevering in forcing more austerity. Paradoxically, the confidence theory returns as a boomerang to the same policy-makers: it is now clear that the austerity strategy has undermined confidence and is causing the sovereign debt crisis to spread indiscriminately. Austerity has led to fear and panic. The latter will not subside by applying more austerity.

The austerity strategy should be changed quickly. First, the European Commission should forthrightly declare that since the eurozone is quickly moving into recession, the austerity programmes should be

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softened and spread over a longer period of time. This should allow the automatic stabilisers in the national budgets to prevent the economies from spiralling downwards. In addition, some countries whose spending levels exceed their production should start budgetary stimulus so as to reduce the gap between output and spending.

Second the ECB should take up its role of lender of last resort in the government bond markets of illiquid but solvent member countries of the eurozone. With the exception of Greece, all other member countries should be given the benefit of the doubt and be considered as solvent provided they can have access to funding at reasonable interest rates. The ECB can ensure that these countries can have access to funding at reasonable interest rates.

It is essential that the ECB's bond-buying programme should be organised in such a way that it can create confidence in the market. This is not the case today because the ECB has announced that its bond-buying programme is limited both in size and in time. As a result, investors fear that as soon as the ECB would stop making its purchases, bond prices would go down. This would lead to a permanent selling dynamics, forcing the ECB to buy a lot of bonds.

Instead the ECB should announce that it intends to use its unlimited resources for as long as necessary. In addition, it should announce a clear target – for example, in the case of Italy a long-term interest rate not higher than say 250 basis points above the risk-free German bond rate. This would constitute a sufficient penalty rate to induce the Italian government to reduce its budget deficit.

Objections to this approach appear increasingly trivial. The problem today is fear and panic in the sovereign debt markets. This panic risks engulfing the whole banking system in the eurozone, and ultimately the eurozone itself. When the eurozone risks collapsing, the strength of the objections is reduced to zero – at least for those who care about its survival. But who knows? Some in Frankfurt may not care about the survival of the eurozone.