CEPS COMMENTARY
Thinking ahead for Europe

'Yes we can' Europe can solve this crisis – if it wants to

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The warning by a major ratings agency that it might downgrade 10 euro area countries, including Germany, has served as a timely reminder to European policy makers that they must now find a solution to a crisis that has been allowed to fester for too long. But what is the nature of this crisis? The headlines on concepts such as 'fiscal compact' or 'fiscal union' suggest that excessive deficits are the key problem of the eurozone. But the numbers suggest otherwise: the euro area has in aggregate a fiscal deficit of 'only' 4% of its GDP, much lower than the 10% of GDP for the US. Moreover, the IMF foresees the deficit going down to 3% already next year and continuing to decline after that. Such figures do not suggest an acute fiscal problem, at least for the euro area in aggregate.

Fiscal deficits usually create problems if they cannot be financed at home. But this is also not the case for the eurozone, which does not have an external deficit. This means that there are enough savings within the monetary union area to finance all public deficits of the eurozone's members. There are more thus enough resources within the eurozone to solve its debt problem.

But if there is no aggregate problem, why has the euro crisis gone from bad to worse? The key problem is the distribution of savings within the eurozone. There is an excess of savings north of the Alps; but northern European savers do not want to finance the southern countries such as Italy, Spain and Greece. This is the reason why the risk premia on Italian and other southern European debt have gone to 500 basis points and why, at the same time, the German government could at times issue short-term paper at negative rates (yes, the German government was being paid to take care of your money for a few months). The reluctance of Northern European savers to invest in the euro periphery is the root of the problem.

The German government could of course change this if it were willing to guarantee all Italian, Spanish and other debt. But, understandably, it is reluctant to do so.

The European Central Bank could also 'solve' the problem if it became the buyer of last resort for all the debt shunned by financial markets. But it is also, again understandably, reluctant to do so.

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So the stand-off continues and the crisis becomes worse because markets fear that a large country, for example Italy, might suddenly find itself without liquidity, which would drive it immediately into insolvency. This would be catastrophic for the European (and indeed global) financial system and would certainly lead to another 'great recession', if not depression as many commentators have warned. This danger of a systemic breakdown is the reason for the nervousness in financial markets and the background to the warning from the ratings agencies.

The task for this European Council is to find an agreement that can resolve the implicit stand-off between the ECB and the politicians. A formula must be found that allows Angela Merkel and Mario Draghi to declare victory (something that can be called a fiscal union), but is still acceptable to all other member countries. If this can be achieved, the ECB will presumably feel empowered to provide a liquidity backstop until the tensions subside. This does not imply that the ECB should go out next Monday and buy massive amounts of Italian and Spanish debt. It will be enough if investors know that the ECB will in future stand ready to intervene should risk premia rise again to unreasonable and unsustainable levels. Even with the best agreement, the crisis will not suddenly be over, but it could at least be contained, thus giving countries such as Italy or Spain the time they need to show that they can get their deficits under control and turn their economies around.