

Europe : small steps and giant leaps

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We were expecting eurobonds and we got economic governance. According to Angela Merkel and Nicolas Sarkozy the great leap forward would perhaps be the culmination but for the moment small steps are the order of the day. The question is obviously whether small steps serve any purpose.

To answer this, we need to go back a little in time. Until the end of spring the sovereign debt crisis was confined to three small countries, Greece, Ireland and Portugal. Spain had succeeded in limiting its spreads with Germany to about two percentage points. But by mid July the cost of borrowing for Spain and Italy was nearing four points and France's borrowing conditions were rapidly worsening. The spectre of a fully blown crisis was starting to haunt markets. But the euro area was not equipped to deal with this. The stability fund created in 2010 had a lending capacity of a little more than 300 billion euro, ample for the peripheral countries but too little to help even Spain alone. Disaster threatened.

On 21 July European leaders attempted – belatedly – to cure this vulnerability. They increased the capacity of the stability fund to allow it counter the Spanish and Italian risk and authorised it to act before the outbreak of a crisis by intervening on secondary debt markets in order to reduce bond rate spreads. The fund is not equipped to deal with a simultaneous crisis in Spain and Italy but it can try to prevent them happening. More accurately, it will be able to do so once national parliaments have ratified the agreement. In the meantime the European Central Bank is intervening in its stead, quite successfully until now : the tension has eased markedly since it began buying bonds on 8 August.

This response is based on the hypothesis that, unlike the Greece crisis which is a genuine case of insolvency, the Spanish and Italian crises are mainly attributable to self-fulfilling speculation. Here, markets are guided by groundless fears which are nonetheless perilous because they have a negative impact on borrowing conditions. In such a case, limited and credible intervention should suffice to flip the trend, but there is no guarantee. And if intervention fails, even boosting the fund to 1 or 1.5 trillion euro would be inadequate because there would be a crippling domino effect on the countries standing guarantee for others : a Spanish crisis would affect Italy, an Italian one would hit France, and a French one would leave Germany as virtually the sole guarantor of a debt burden which it would be unable to bear.

Issuing eurobonds would mean replacing the strategy of 'every man for himself' by one of 'all for one and one for all', as it would enable joint borrowing by euro countries. Each would benefit from the guarantee of all its partners, and only the aggregate situation of the euro area would count, which is significantly better than that of the US, Japan or the UK. The idea is attractive but it must be realised that a joint guarantee implies, for each of the participating countries, giving partners access to their own taxpayers, who may be required to stand in for a defaulting borrower. This arrangement is unthinkable unless there is an extremely robust counterpart, for example prior scrutiny of national budgets. In concrete terms, a country may be



faced with the choice of having a finance bill adopted by its parliament but deemed insufficiently cautious repealed, or facing the withdrawal of the joint guarantee.

Decisions of this nature cannot be left to a committee of technocrats nor to a conclave of ministers. They can only be taken by a body with analogous democratic legitimacy to that of a national parliament. In other words, issuing eurobonds entails setting up a kind of federal system of government, recognised as such by the states and peoples of Europe.

No doubt Angela Merkel and Nicolas Sarkozy find this prospect highly unattractive. But their proposal may in practice boil down to a response in two parts. In the immediate, bolstering European governance by appointing Hermann Van Rompuy as a permanent chairman of the euro area conveys a signal about the cohesion of the euro area designed to calm markets and support the strategy of 21 July. If this were to prove inadequate and a more ambitious strategy were to be needed, the existence of a governance structure, or at least the beginnings of one, would form the basis of more elaborate machinery.

With luck, the first part of the response will be enough, because it is far from certain that the second would be politically acceptable. But the decision lies only partly with governments themselves. Since the outbreak of this crisis they have been continually forced by events to push European integration further than they had initially envisaged. It may well be that these small steps lead in the not-too-distant future to the great leap.