**From the periphery to the core: the unstoppable journey of the Euro debt crisis**

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Germany’s triple A rating has been given a negative outlook by ratings agency Moody’s, amid ongoing woes in Greece, Spain and Italy. AAP

On 23 July, the rating agency Moody’s put the triple A debt of Germany, the Netherlands, and Luxembourg [on a negative outlook](http://www.spiegel.de/international/europe/moody-s-cuts-outlook-for-germany-to-negative-from-stable-a-846020.html). The day after, the outlook on the European Financial Stability Fund was also downgraded to negative.

Moody’s assessments certainly influence markets, but this does not mean that they are always justified and correct. In this case, however, it does not come as a surprise to know that the long wave of the crisis in the EU periphery has finally hit the core.

This negative outlook is only one of the many bad news coming from Europe these days. The stock markets of several countries recorded large losses at the beginning of the week. The yields on the sovereign debt of Italy and Spain reached new, worrisome heights on July 24.

In Spain, various regions seem to be at risk of default. Valencia and Murcia have already said they will tap the emergency credit line the central government recently set up for cash-strapped regions. Catalonia and others might soon follow.

Reports from the EU indicate that Greece is unlikely to meet its bailout terms, meaning that its permanence in the Eurozone is seriously in question.

Other additions to this “war bulletin” are the demonstrations of the unemployed in Spain, the resurgence of political instability in Italy, and the diplomatic incident that involved Spain, France, and Italy over a joint message to the EU Commission for the implementation of the decisions made at the European Council of June.

How did Europe get to this point? And, more importantly, should the world prepare for a hard landing or there is still a chance that Europe will recover?

**The perfect storm**

In a few years from now, when economists will write a chronology of the crisis, it will be difficult for them to establish where the global financial crisis (GFC) ended and the European debt crisis began. Government expenditure in most European countries started growing in 2008 in response to the early signs of the GFC and then peaked in 2009, with the implementation of fiscal stimulus packages.

**The rapid expansion in expenditure eventually led to a significant increase in the debt to GDP ratio**. If this increase in debt had been the only adverse event, we probably would have not had a crisis of the proportion we are witnessing today. But at least two other crucial factors - both negative - were at play.

First, some underlying economic weaknesses magnified the vulnerability of the peripheral countries to the debt crisis. In Italy, for instance, the economy had been almost stagnant for 20 years before plumbing into the deep recession of 2008-09. **In Spain, we know now, banks were fuelling the housing bubble while adding highly risky assets to their portfolios.** In Greece, fiscal accounts were in much worse shape than what appeared from the official indicators. Portugal and Ireland were also growing on much weaker fundamentals than expected.

Second, the institutional architecture of the European Union was (and still is) incomplete and hence unable to provide its member states with adequate shelter in a crisis situation. The problem is well known: the EU is a currency union without underlying fiscal union, without a lender of last resort, and without a supranational banking supervision authority. Moreover, the political supranational institutions, like the European Parliament and the European Commission, suffer from a deficit of credibility which arises from the limited powers and roles they have been institutionally assigned as well as the fact that national electorates do not perceive them as sufficiently representative.

Overall, this institutional architecture distorts the incentives of national policymakers and does not foster cooperation on fiscal and financial matters.

Put the increase in debt, the underlying structural weaknesses, and the incomplete institutional architecture together. Add some self-fulfilling prophecies and stir. What you obtain is an explosive mix: the perfect storm.

**Where to go from here?**

The analysis of the drivers of the crisis suggests that the two key conditions for a stable, long-term solution of the European problems are: (i) return to sustained economic growth and (ii) stronger fiscal, financial, and political integration.

In the end, economic growth is what makes the debt sustainable. When the economy grows, unemployment declines, and social tensions lessen. Of course, relaunching growth is a big challenge. In this regard, the frontline will be Italy, where the growth rate has averaged just above 1% since 1994.

What Italy needs is a set of ambitious reforms of the labour market, the public administration, the judicial system, and the social welfare system. The technical government of Mario Monti was expected to start these reforms, which none of the previous political governments had been able to implement. Unfortunately, so far, Monti’s government has not done much beyond a package of fiscal austerity measures, which have brought tax pressure up to 55%.

Arguing for greater fiscal, financial, and political integration in this time of crisis of the common currency might seem a paradox. For sure, many in the peripheral countries of the EU erroneously blame the euro for their current problems. And if a referendum were held today, any attempt to implement measures aimed at strengthening integration would be likely rejected in most countries.

Still, a more fiscally integrated union would provide its members with the means to prevent fiscal profligacy in individual countries. A practical measure to achieve this is to establish that countries in violation of the fiscal stability criteria lose their sovereignty on fiscal policy. This means that when a country violates the targets on deficit and debt, its budget law is written by the European Commission and approved by the European Parliament. For this mechanism to be effective, however, reforms are needed to raise the profile and credibility of the supranational political institutions; hence the need for stronger political integration.

By a similar logic, banking surveillance and supervision should be centralised in the European Central Bank. This would make banking activities more uniform across countries and less prone to political interferences.

**Changing the course of the crisis**

There are two events that can precipitate the crisis towards the point of no return. One is a further sudden increase in Italian and Spanish sovereign debt yields. The other is a sequence of bank runs, starting from Greece or Spain and rapidly expanding to the rest of the periphery.

Both these events could happen almost overnight, implying that reforms to spur long-term growth and foster integration must be complemented by actions capable of sending quick, credible signals to markets, investors, and savers.

The first of these signals might be the announcement of a mechanism to purchase as many bonds as necessary to cap sovereign debt yields at, say, 6%. If perceived as credible, this announcement would take insolvency off the table and hence investors would no longer want to sell bonds. As a result, yields would decline without need for bonds to be actually purchased.

The institution that above all the others could credibly make such announcement is the ECB. In fact, the ECB has for long opposed large-scale bond buying. But just on the morning of July 26, the ECB President Mario Draghi announced that [his institution is ready to do anything](http://www.huffingtonpost.com/2012/07/26/mario-draghi-ecb-euro_n_1704847.html?utm_hp_ref=business) to save the euro. Following his statement, the interest rates on the Italian and Spanish bonds immediately started to decline.

Alternatively, the European Stabilisation Mechanism (ESM) could be used to buy bonds on the secondary market to stabilise the yield, very much in line with what was agreed at the European Council of June. The problem in this case is that the ESM has a limited capital endowment. The solution would be to give ESM a banking licence or to allow it to access the ECB liquidity. In this way, the ESM would, in practice, become a lender of last resort.

The second signal capable of changing the course of the crisis is the creation of a European guarantee on bank deposits. This could be established through the ESM or some analogous mechanism and it would take the form of a commitment to refund all deposits in euro, no matter what happens to the currency and/or the banking sector.

All these actions, announcements, and commitments are certainly very demanding. To be credibly carried out, they require political will, resources, and vision. But the EU cannot be saved otherwise. The perfect storm is not going to clear by itself. You have to navigate out of it or your boat, with all the passengers on board, will sink.