Europe's Crisis of Credibility

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It is a privilege to appear before the Senate Committee on the Budget.

Europe's crisis is not a currency crisis. Sound monetary policy has kept the Euro at $1.30 within its past range of $0.85-1.60. Europe has a fiscal crisis compounded by a failure to take corrective action that has destroyed its credibility in the capital markets.

I. Self-Inflicted Crisis: No Discipline and Credulous Markets

The European monetary union limited government deficits to 3% of GDP and national debt to 60% of GDP. Markets accepted this fiscal performance guarantee at face value and believed sovereign credit risk was homogenized. The interest rate differential between the strongest member Germany and the weakest member Greece fell from 8% per annum to 0.2%.

However, the fiscal rules were never enforced. By 2006, 7 of the original 12 members were over the 60% debt limit. By 2010, 10 exceeded the limit. Weak governments used massive borrowing to offer their citizens a standard of living their productivity could not deliver. The crisis began in October 2009 when Greece announced a doubling of its fiscal deficit and markets saw their error. Two years ago, Greece should have defaulted on its debt and other spendthrift governments should have tightened their budgets.

The fundamental problem is that European policymakers do not understand markets, do not like markets and believe they can control markets. They live in financial pre-history and always choose pressure and regulation over incentives and market forces.

II. Disagreement over the Responsibility of Members: Accountability Versus Solidarity

Europe's inability to act in the face of a crisis stems from a core disagreement over the responsibilities of Union members. Without fundamental agreement, all actions have been failed political compromises that further erode market credibility.

Germany leads the North. The cause of the crisis is a lack of discipline in the South. Profligate members must cut spending, lower wages and increase productivity. The path Germany itself used to gain its current prosperity. Each member is responsible for its own fiscal and economic wellbeing. If markets see credible action, interest rates will fall and the crisis will end.

Southern Europe believes their troubles are caused by Germany's success. Union solidarity requires massive transfers from strong members to the weak. A collectivized Eurobond will lower financing costs and minimize adjustment pain.

France, instead of siding with other AAA members, has appointed itself head of the South to capture European political leadership while leaving the cost of bailouts with Germany.

III. The Monetary Printing Press: Mimicking the Federal Reserve

Germany wants immediate strong fiscal correction by individual governments. The rest of Europe and the Obama administration want a quick fix where the European Central Bank

(ECB) prints EUR 2 trillion and buys every weak government bond in sight until yields are driven down to 4%. They believe the real problem can be dealt with later.

Germany disagrees. If a long term solution is not offered, no amount of money will make stop-gap measures work. If Germany capitulates, a currency crisis will be added to Europe's fiscal crisis.

IV. Stable Monetary Union and Collectivized Euro-bonds

Since the Euro's inception, members have struggled with the conflict between central control and national sovereignty.

There are two forms of stable monetary union:

1. Members share a currency but each government stands on its own before its creditors. Markets take losses, impose discipline and set borrowing limits; or

2. The Union underwrites all its members. Then the Union takes losses and must impose discipline and set member debt and spending limits.

A monetary union that cannot make up its mind is a crisis waiting to happen and Europe is still struggling to make up its mind.

The debate over the creation of common liability Euro-bonds is a false argument. If fiscal control is achieved: There is no need. All members will be AAA. Without control: Euro-bonds are not viable. As one of the German Parliament's Economic Policy leaders said: "They are the devil's work".

V. Germany's Vision: The Next Level of Europe

Germany has now found the tools to force Union fiscal discipline after two years of reasoning, threatening and pleading had no effect.

Market forces can succeed where diplomacy fails. Painfully high interest rates compel politicians to make necessary choices. Removal of the unanimity requirement on Euro-zone decisions takes away the veto right of prodigal members. There will be no access to emergency aid without agreement to the fiscal compact. The fear of being left behind without support will force submission to fiscal reform.

Over the next 2-3 years, Germany will drive the Euro-zone toward a fiscal union with central control over national budgets and strong automatic sanctions against spending offenders.

This is a difficult path. The greatest danger is that if a crisis looms, politicians will confuse the end of their world with the end of the world, bail out every government and bank in sight and set economic stability back a decade.

The strong arm of the ECB is needed to support the path to the European fiscal compact and maintain stability in fragile markets. The ECB should announce a rule of intervention that removes the risk of financial panic but preserves incentives for investors and politicians and safe-guards its inflation-fighting credibility.

VI. Europe's Long Term Problem

Europe's excess debt can be solved: write it down. Europe's excess deficits can be solved: cut spending.

The difficult problem is that Southern Europe's populations expect a life-style their productivity cannot supply. Greeks don't have to be Germans but then they cannot expect to be paid like Germans.

The 25% gap between Southern Europe and German labor costs can only be closed by nominal deflation because devaluation is not possible within the currency union. This is a long painful process that will precipitate a 5-7 year recession in the uncompetitive economies.

The only other alternative is a long term transfer from Europe's productive North to the easy-going South. The reunification of Germany posed the same problem of differing productivity. A solidarity tax was imposed to bring the former East Germany up to West German standards. Envisaged as a temporary transition mechanism, it is still in full force 20 years later.

Northern Europe will pay the transfer directly through taxes and aid and indirectly through higher inflation to reduce Southern Europe's debt.