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Commentary

The E.U.'s Aggressive Bailout Plan

Jagadeesh Gokhale, 05.11.10, 03:42 PM EDT

Is it an experiment in levitation?

The "shock and awe" bailout package announced by the European Union--a $955 billion bailout for member governments--is an attempt to defy the centrifugal forces of past fiscal profligacy and subterfuge on capital markets. It is clearly provoked by the most obvious symptom of the failure--a steady depreciation of the euro on world currency markets, from $1.51 in December 2009 to its current value of just $1.30.

This decline in the euro's value reinforces the lesson that the consequences of flouting the fiscal ground rules of a monetary union are inescapable. The Maastricht Treaty founding the eurozone laid down these rules, limiting member nations' debt-GDP ratios and annual deficit-GDP ratios. But after several rule violations during the early 2000s, including some by major eurozone countries, and unwillingness to acquiesce to the pact's tough penalties during economic recessions, eurozone members gradually weakened the pact's fiscal stability conditions. The current crisis, starting with Greece but clearly imminent in Portugal, Spain and Italy, is just the latest episode reflecting the difficulties of operating a monetary union without reasonable and strictly enforced government spending and debt limits.

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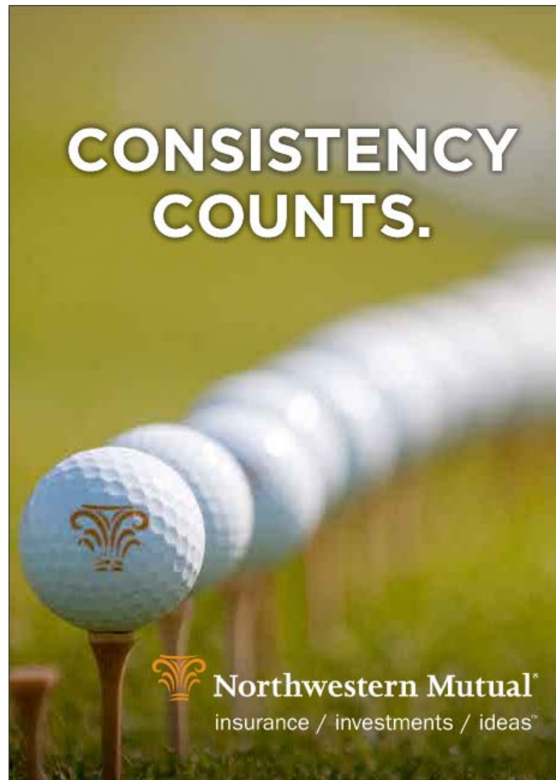
Now the dismal arithmetic of euro depreciation is quite simple--expected further depreciation will keep investible funds out of Europe and threatens to unleash a vicious cycle of declining competitiveness and low investment that will erode living standards--not just for the fiscally profligate, but for *all* eurozone nations.

This is a consequence of the poor incentives inherent in a monetary union sans political union. A monetary union reduces economic uncertainty for traders and increases economic efficiency. But it leaves member nations bereft of monetary policy and currency devaluation mechanisms--tools that can help to manage members' particular economic circumstances. But the lack of a political union leaves each eurozone country free to pursue high-debt fiscal policies, the benefits of which accrue within the nation while costs fall on all other members. If all or a sufficiently large number of members flout the monetary union's fiscal constraints, that union can no longer function effectively--and neither can the European Central Bank successfully pursue its key goal of ensuring price stability.

Will the massive bailout announced by E.U. officials stem the tide? Obviously, if a government is facing a severe debt crisis, it cannot simply announce that it "stands firmly behind its bonds" and expect market participants to resume buying them at low interest rates. The only remaining option for a monetary response lies with the European Central Bank, which until now has favored inflation control over economic



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growth. With the Euro depreciating rapidly, the ECB has been forced to react by stepping in to purchase member nations' debt. This action will prevent European interest rates from increasing sharply in the short term. However, it can work only if inflation expectations remain contained. If similar ECB interventions become too frequent, those expectations would likely unravel and negate the goal of maintaining low eurozone interest rates.

In the Greek case, critics have claimed that dithering by E.U. officials in agreeing to a bailout package injected unnecessary market uncertainty and worsened the crisis. But dithering has its uses. In the case of the Greek crisis, it served to extract promises from Greek politicians of imposing significant fiscal austerity. For the Greeks, making such promises now is, of course, rational. It brings in bailout funds and spreads the cost of structural budget changes over four years. Without those funds, market aversion to Greek government bonds would force much larger and more painful budget cuts. As recent violent outbursts by the Greek populace indicates, delivering even the promised cuts in government employee payrolls, pensions, health, welfare and other benefits will be quite difficult.

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Unfortunately, the latest bailout package reverses the logic of first negotiating a fiscal consolidation plan before committing bailout funds. The better course would have been for eurozone members to announce a coordinated round of budget consolidations and to reawaken and rearm the Stability and Growth Pact that has been all but abandoned since 2005. Without fundamental spending reforms--and that means reducing large unfunded government obligations on pensions, health, and welfare programs, Europeans may soon revisit the crisis atmosphere that appears to have been contained for the time being.

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