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Commentary

Forget The European Monetary Fund

Jagadeesh Gokhale, 03.17.10, 12:01 AM ET

The debt crisis in Greece has European economists befuddled--and clutching at ideas like establishing a European Monetary Fund, which is likely to undermine, not enhance, the stability of the European Union.

Greek politicians and budget officials played fast and loose with budget accounting tricks to hide their profligate spending sprees in years past. Now Greece faces debt repayments of $30 billion in April and May 2010. It's not yet clear whether financial markets will acquiesce to rolling over that debt without demanding significantly higher interest rates--a prospect that is causing widespread consternation and a scramble for a quick solution.

Greece failed to observe a fundamental requirement of the monetary union: "stability." But the E.U.'s Stability and Growth Pact was diluted in 2005 to accommodate budget-deficit-rule infringements by France and Germany during the early 2000s. Greece's "bad behavior" could be directly attributed to the poor incentives created by that back-door bailout.

Now individual European countries are refusing bilateral aid to ease the economic austerity that Greeks must now endure. That's not surprising because any such commitment would be opposed by voters and could be contested in the courts. So the immediate crisis will probably be resolved through a one-off loan funded by a "coalition of the willing" among E.U. nations.

For the longer term, some economists are promoting the establishment of a European Monetary Fund (EMF), structured along the lines of the International Monetary Fund. This is a bad idea.

According to the proposal, the EMF would borrow on financial markets and provide conditional assistance to member countries when they face debt crises. EMF proponents envision that it would make Eurozone nations' commitments to fiscal discipline and crisis management more credible. Exactly the opposite is likely to be true.

European economies face a classic free-rider problem. Domestic fiscal profligacy--public spending beyond the nation's willingness to pay--generates short-term domestic benefits but also long-term costs that are shifted to all other Eurozone members through higher interest rates. Higher deficits siphon away capital that would otherwise be invested in the private sector, which increases interest rates. The Greeks pushed the envelope in playing this game to the detriment of its European partners.

But other major European countries also face prospects of rising budget deficits because of their generous social insurance programs and aging populations. Thus, Spain, France, Germany, Portugal, Italy and other E.U. nations must also introduce fiscal consolidations--mainly spending reductions in pension, health, welfare and other government programs because European tax rates are already very high. Without such adjustments rising budget deficits would signal higher inflation risks and erode international credibility in the newly created Euro as a secure currency.

The hope that fiscal discipline among E.U. members would become more credible with the creation of an EMF is misguided for several reasons. First, EMF borrowing on financial markets would immediately siphon off investible capital and increase interest rates. If the EMF is sizable, it would make public borrowing by national treasuries more costly, directly and immediately.

Second, the creation of such a fund would create a "moral hazard" much like the IMF already does with its now expanded ability to provide economic assistance to countries facing exchange rate or debt crises. The possibility and increased expectations of bailouts by a new EMF would promote more, not less, fiscal profligacy by the Greeces of the world.

Also, in which assets would the EMF borrowings be invested? If in E.U. national treasury bonds, the interest rate effect would be neutralized, but it would reallocate capital from private investment to public coffers on net, to the detriment of long-term economic growth. To ensure a credible commitment to crisis avoidance, the fund should be invested in non-European financial securities. But that would remove investible resources from Europe--something member nations are unlikely to support.

Finally, investing the fund in privately issued European securities would run counter to financial management principles: It would increase the risk of investment losses precisely when EMF monies are required to provide bailouts to national governments.

To sustain the Euro's credibility on international markets, E.U. nations need long-term fiscal stewardship to generate the needed budget savings. All E.U. members should participate in a coordinated budget consolidation process regardless of their economic and business cycle positions. Consolidations should be contingent on country demographic profiles, budget structures, financial vulnerabilities and revenue capacities. Without such proactive policy adjustments, wrenching market adjustments are likely to eventually spring unpleasant surprises--and indiscriminately--on European citizens.

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