Europe: Headed Right but Not Fast Enough

Edwin M. Truman analyzes four aspects of the crisis: Greece's prospects, the threat of contagion, the weak banking system, and the need for a new fiscal union.

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Steve Weisman: With Europe stumbling toward either a solution or further chaos over its sovereign debt crisis, this is Steve Weisman at the Peterson Institute for International Economics with Ted Truman, senior fellow at the Institute to talk about which direction Europe is headed in. Ted, which is it?

Edwin M. Truman: It's headed in the right direction. The question, I think, is whether it's going to get there fast enough or whether the goal posts are moving faster than the progress down the field.

Their challenge, I think, is that they have four separate and inter-related problems. One is to deal with the crisis countries, Greece, in terms of stabilizing them and getting them to start to grow again. The second is that they need to have enough resources so that they can build a financial firewall to deal with the contagion effects of what's going on in Greece and other countries, in particular with respect to Italy and Spain. And that's where the European Financial Stability Facility [EFSF] comes in. Thirdly, they have issues about how strong the banking [system] is and whether they can provide the kind of support that it may need as sovereign debt in Europe is downgraded and may be written down, and the European economy slows and therefore more bad loans show up on balance sheets. And lastly, they need a solution to their existential crisis about the euro and the euro zone, which involves creating more of a robust economic government structure. This, I think, is important: to have a vision of where the euro zone is going in the future, because it would provide the kind of bridge or the pillar to a bridge that has to be built by existing European institutions and particularly European Central Bank, which seems to be at the moment resisting the idea that it should be even more a part of the solution than it has been over the last two years.

Steve Weisman: Let's take the first problem of Greece. Its growth prospects are poor. By some measures, every time it meets its austerity targets, as you put it, the goal posts move further away. Can Greece make it without a further write-down of its debt, and will the banks suffer from that?

Edwin M. Truman: I think in the end Greece will need to have a further write-down of the debt. Although I have not been in a position to say we need to do it now, I think you're close to that point now. So the notion that there's going to have to be a 50 percent or more haircut to just lift the burden is part of the solution. It won't be all of the solution, because even then, it won't immediately put Greece into what we economists call a primary budget surplus and so Greece will still need to be financed as it cuts its budget deficit and goes into surplus, which is necessary for it to bring the remaining debt level down as a share of GDP. And it will have to undergo certain structural changes, difficult structural changes, to recover growth in Greece.

But I think the central question is that other parts of Europe can actually help Greece grow. There is a resistance -- to put it crudely and superficially – in Northern Europe to the notion that they should let up on their own fiscal austerity in the name of European growth. The resistance so far on the part of the European Central Bank to cut its interest rates, which is at 150 basis points and could be cut down to the 25 basis points you find in the rest of the advanced-country world. And so there are things that could be done for Greece on the growth side, but most of the work still has to be done in Greece itself. And lightening the debt burden is part of the solution, but certainly it's not the whole solution. But I think it's inevitable at this point.

Steve Weisman: Let's go to the firepower of the European Central Bank and the European Financial Stability Facility. Are they moving toward enough lending-power to make people think that this problem can be prevented from spreading to the core of Europe?

Edwin M. Truman: I think the answer to that question is: "We don't know." I think if what is done is limited to leveraging the residual resources and the EFSF to provide limited guarantees to certain countries that need to borrow, like Italy and Spain, and perhaps provide some capital to some European private financial institutions, that will not be enough. They need to have much more. They need to have access to the liquidity, not the loss-absorbing facility but the liquidity of the ECB in order to leverage in one way or another the equity that's been provided by the EFSF. And as far as one can tell from the negotiations that get revealed in newspapers, they are not there yet. The Germans have not agreed to that and Europe and the ECB itself have not agreed to that, even though it would appear that at least the French have, maybe for their own reasons, recognized that using the combination of instruments to deal with this problem of firepower is essential.

Steve Weisman: If there is a write-down along the lines of what you suggested earlier, can the region's banks raise the capital in the private markets or are they going to have to turn to the governments for help?

Edwin M. Truman: I think it's more complicated and nuanced than that. I think it's not just a question of raising everybody's capital level to X so that everybody can absorb some hit, which is unknown in terms of the size. There's the Greece component. There is the possibility, even though they deny it, of write-downs of other sovereign debt in connection with Ireland and Portugal. There is the weakness in the European economy. The real issue is that in some sense the bankers are right. This is not the right time to add to your capital. The question is whether the weak institutions impacted by that will end up being insolvent, and therefore have to be resolved. And so, you really are more in a situation, it seems to me, of trying to resolve weak institutions.

Steve Weisman: Meaning weak banks?

Edwin M. Truman: Yes, in a European-wide sense. So far, it has been each country takes care of its own regardless of how worthy it is that the institution X, Y or Z should be preserved, because it happens to be Italian or Austrian or Belgian or French. And the European banking system should be consolidated. It needs to be consolidated on a European-wide basis. And it shouldn't be consolidated on the basis of the countries that are rich enough can support their banks even if those banks are weak themselves and should be liquidated. The banking system as a whole should be shrunk.

Steve Weisman: Finally, on your fourth point about the possibility of a fiscal or political union in Europe -- that's a long way off, isn't it?

Edwin M. Truman: It certainly is a long way off, and it would require to [be done] right. I don't pretend to think I know precisely the right way to do it. It will require both treaty changes in Europe and almost certainly constitutional changes in Germany and probably some other countries to allow for some additional sharing of sovereignty within Europe.

But what you need is more of an economic government structure. To put it crudely, you need something for the ECB as the euro zone-wide central bank to deal with, so it doesn't have to deal with the finance ministries and the governments of seventeen countries, but can deal with an authority that actually can commit Europe to do the right thing on what finance industries do. And that presumably also has a political component in terms of the role of the European parliament. So they need to move closer to a political union than they are now. That will involve difficult choices. But if they can articulate a reasonably clear vision, I think that would help to resolve some of these issues. I'm not trying to say that any of them will be easy to resolve. That's actually the risk, that if any one of these pieces could fall apart, that will call into question the capacity of Europe to put this crisis largely behind itself.

Steve Weisman: Ted, thanks.

Edwin M. Truman: My pleasure.