



Toward a European Fiscal Union, Part II

C. Randall Henning explains why Spain illustrates the shortcomings and opportunities for resolving the European economic and financial crisis.

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Steve Weisman: This is Steve Weisman at the Peterson Institute with Randall Henning of the Institute and American University for the second segment of our discussion about the need for a fiscal federalism, especially in the banking area in Europe, following the precedent of hard experience of more than two centuries in the United States. Randy, you've outlined why Europe would be well-advised to follow the American example. Let's talk specifically about the case of Spain. What is the biggest challenge that confronts Spain, and how might a different structure of the European Union help it in the future?

C. Randall Henning: Yes, many of us are looking at Spain closely now because it's experiencing stress in terms of its finances. The challenges facing Spain are several. But there are two critical interlinked problems at the moment. One, of course, is the government budget deficit and the risk that Spain may not be able to finance that without going to official sources. The second is the problem of restructuring the Spanish banking system and the costs associated with that.

Taking the first half of this problem, Spain had last year a budget deficit which was about 8.5 percent of GDP. This year, it is to have a deficit of 5.8 percent of GDP. Next year, that is supposed to go down to 3 percent of GDP. Well, Spain is now in a recession and unemployment is almost 25 percent. Youth unemployment is 50 percent. In the face of this, they are going to have to introduce spending cuts and tax increases. It is impossible to do this, I believe, while restoring growth next year, which is what is still in some of the official forecasts. So, they're going to have to acknowledge this if they're going to have credibility in the markets.

This is tied in, I think, in an interesting way with the problem in the banking system, because that will require recapitalization of some of the Spanish banks. And the cost of that is going to have to be borne by the Spanish government. Doing that is going to blow a hole in the fiscal accounts. That's not included either in these projections of moving to a 3 percent deficit next year.

Steve Weisman: Are you suggesting Spain simply cannot do this on its own and needs help from the countries that are growing in Europe in some way, either through the European Central Bank or some other mechanism?

C. Randall Henning: Yes. It's a strong argument for moving toward a collectivization of the cost of bank restructuring in Europe. This should be done at the euro area level. The one mechanism for doing this is to use the existing facilities, the EFSF [European Financial Stability Facility] and the European Stability Mechanism [ESM] which comes into being in a couple of months, to use these to recapitalize the Spanish banking system.

Steve Weisman: Is Europe heading in that direction?

C. Randall Henning: These are available to do this, but the hitch is that as presently constituted, the money flows through the Spanish central government into the Spanish banking system. What many are advocating is direct recapitalization from these European facilities into the Spanish banks, bypassing the sovereign, breaking the link between the sovereign on the one hand and the bank system on the other, which makes the problem more difficult.

Steve Weisman: Why would that be better?

C. Randall Henning: In many of these countries, the sovereign and the banking system are so closely tied that when one has a problem, the other loses access to the credit markets. Whatever we can do to break the link between the financial situation of the sovereign and the financial situation of the banks would be helpful. If we can direct funds from the European level to the Spanish banks directly, then we can help the Spanish banks without putting the Spanish central government into greater debt.

Steve Weisman: But this implies an architecture of regulating banks across Europe that doesn't exist now?

C. Randall Henning: The Europeans are moving in this direction. They haven't gone nearly far enough and so they will have to go further. The other thing that is critically important for the politics of this is that the governments of the member states would have to be comfortable with allowing themselves to be bypassed in this way. That is tricky because these banking systems are deeply embedded into the political structures of these member countries.

Steve Weisman: And in the localities even.

C. Randall Henning: Absolutely. It goes down to the provincial level.

Steve Weisman: Thank you, Randy, for walking us through.

C. Randall Henning: You're welcome, Steve.

