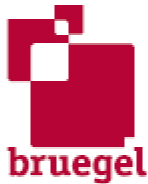

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# The euro sorely tested by national crises.

*By Jean Pisani-Ferry*

They all looked the same for a long time. The reckless and the virtuous ones, the sneaky and the upfront ones, all the member countries of the euro area were treated identically, or nearly, by capital markets. Bond spreads were minimal, as if sharing the same currency had eliminated all the differences between them.

Not any more. Having reached one percentage point in October and two in December, the bond spread between Greece and Germany is continuing to widen. Ireland is not far behind, and Italy and Portugal are hot on its tail. As for Spain, it has just been downgraded like Greece.

It is not too difficult to see why Greece is a worrying case. It has built up a very high level of public debt (94% of GDP), a whopping current-account deficit (13% of GDP, three times higher than that of the US) and a rate of inflation regularly higher than its partners. Greece has experienced a period of serious social unrest, hinting at the deeper malaise. Markets remember that it was only after Greece's entry into the euro area in 2001 that the parlous state of its public finances was discovered. These classic ingredients of a crisis of confidence did not weigh heavily in the balance as long as the care-free environment of the last few years lasted. But things are different now, with a recession and a general increase in the aversion to risk.

But just what form an acute crisis of confidence vis-à-vis a member of the euro area might take is harder to guess. We have never been here before. It is of course impossible to speculate against its exchange rate because Greece no longer has a national currency. The most likely reaction is growing investor reluctance to buy its government bonds, with the result that bond spreads would increase, a vicious circle in which its debt would become more and more expensive to service, leading finally to partial

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default. This scenario appears improbable, as we are accustomed to assuming that a state cannot go bankrupt. But a glance at the history books will tell us that this has not always been the case at all.

A sovereign default would inevitably trigger contagion, as financial crises always do. Once the speculators have got their teeth into a victim, they look for another – that is what happened yesterday with US investment banks. So there is a common interest in treating the disease immediately to stop it spreading. In concrete terms, this would mean imposing surveillance of the economic policy of the country concerned and an austerity package in return for the necessary financing. Just the kind of medicine the IMF dishes out in crisis-ridden countries.

The hitch is that Europe is ill-equipped for such intervention. It does not lack the machinery to oversee member states' policies, starting with the Stability Pact. But these procedures are essentially preventive in nature. They are designed to head off a crisis before it happens, not manage it once it is here. The euro area does not have the tools to provide financial support to one of its members and, above all, Europe lacks the experience and the reputation that give IMF programmes their authority. So it is to be feared that, if a serious crisis did erupt in one of members, Europe would turn to the IMF.

This is not an agreeable prospect. The euro area is an integrated group with its own governance rules, and should be capable of solving its own problems. No one has ever called in the IMF to bail out the state of New York or the city of Berlin, so why should it be different for a member of the single currency? Any intervention by the IMF would send a signal that Europe is economically impotent and politically weak.

The problem is that the euro area was built for calm waters and has relied on the power of preventive mechanisms to ward off crises. The very fact that this question arises shows that these mechanisms do not work properly. It also shows that building a fire-wall does not mean that one can do without the fire brigade. But out of a reluctance to centralise and an aversion to mutualise debt, European countries have so far refused this hurdle. The current situation should give them food for thought. It is possibly too late for today's crisis, but not for tomorrow's and the one after that.

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