Muddling through the sovereign debt crisis (2)

Erik Jones concludes his analysis by calling for the creation of eurobonds

The name is Bond, Eurobond: Italy's economy and finance minister, Giulio Tremonti, is one of many experts calling for this new instrument. Photo: Wikimedia Commons

Muddling through may not be very dramatic and yet it is fraught with risk - which is why writers like Wolfgang Munchau and Nouriel Roubini look hard for some alternative. Europe will face moments of high tension, with severe consequences should European politicians fail to organize an appropriate response. As the ratings agencies continue their relentless downgrades of European sovereign borrowers and warnings of impending default, the pressure will only continue to mount. Nevertheless, the balance of forces is likely to prevent movement toward the extremes of political unification or disintegration. European integration has gone far enough to be too difficult to reverse, and yet Europe's citizens are unwilling to see it progress very much further.

Implications

The economic implications of muddling through are important. In the short term, muddling through will fuel volatility in financial markets - particularly as key institutions come into conflict with one another at the international level and member state governments face ever more heated opposition at home. The tension between the Council of Economic and Finance Ministers (ECOFIN Council) over private sector participation is one example; the possibility of an unfavourable ruling on the legality of the first Greek bailout by the German Constitutional Court is another.

The bottom line is that things could still go very wrong. Negotiations over the precise details of the different bailout agreements could founder. Popular unrest either in the peripheral countries or in the core could undermine necessary reforms. A further slowdown in the United States economy could chip away at market confidence. Violence could spread across North Africa and into the more volatile regions

of the Arab world. In other words, just about any strong shock could tip Europe's current strategy for dealing with the sovereign debt crisis out of balance.

In the medium-to-longer term, muddling through will strengthen the divergence between Europe's core and its periphery, even as it reduces the pace of economic activity overall. Growth in core Europe will slow as a result of the crisis; growth in the periphery will weaken even further. Meanwhile, the heightened sense that European financial markets could go badly very quickly weakens confidence in the European economy as a whole. The consequences are all around us. They can be found in volatility of sovereign debt prices and in the decline in producer confidence in April and May this year. The risks associated with tragic miscalculation dominate the headlines and they also create caution in the board room. This not only slows the pace of investment but also hinders the prospects for future growth.

Imagining a Better World

Things do not have to be so fragile. Indeed, there is a proposal floating around that could offer a solution to the sovereign debt problem. This is the proposal for a common European sovereign debt obligation - a Eurobond - that would be jointly issued in order to ensure market confidence but would also provide only limited drawing rights for participating countries to avoid abuse. This proposal was floated most prominently by Giulio Tremonti in an editorial he co-authored with Jean-Claude Juncker last December. In various and subtly different guises, the idea has attracted support from Lorenzo Bini-Smaghi at the ECB and from the European Parliament as well. And it has reemerged most recently in a letter signed by Guy Verhofstadt, Giulio Amato, and a list of other European economic and political heavyweights. Best of all, it does not require excessive European unification in order to function. There is no need for a common fiscal authority and no implicit requirement for north-south transfers. Indeed, the proposal is not so different from the bonds issued by the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM).

A common eurobond simply offers a more equitable, stable, and transparent mechanism for doing much the same refinancing that is already in existence. Hence if muddling through is the most realistic prospect, there is at least one plausible and superior alternative. Moreover, this alternative is much closer to muddling through than either a dramatic step forward in the process of European integration or an even more dramatic unstructured sovereign default. The question now is whether Europe's heads of state and government have the courage to go down that route.

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