PERSPECTIVE

A "Bold and Decisive" Plan for Europe

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For over 150 years the United States has protected its own security and that of its allies by promoting international capital markets and a globalized economy.

America's relations with its European partners have played a significant role in US economic growth, stability and security.

Recently these close ties with the European Union have exposed the US economy to the systemic risks of the Eurozone, which is experiencing an unprecedented debt crisis. Current policy responses - like ongoing bailouts and regulatory reform- are insufficient to jumpstart Europe's weak economies and address its structural deficiencies.

This Perspective Paper argues that the United States should promote two new institutional frameworks--permitting countries to exit the Eurozone and declare sovereign bankruptcy--that will allow European countries to achieve final resolution of their debt exposure and undertake the structural reforms necessary for economic growth.

Last year, Europeans bought $268.5 billion of American goods, making Europe the U.S.'s largest trading partner.[1] But unemployment in Europe is reaching record levels, more countries are entering recessions and even depressions, and Europe's banks continue to fail. And with some of Europe's largest economies facing unsustainable sovereign debt costs, Europe is sinking deeper and wider into public and private debt.

Following the G20 Summit, President Obama called for "bold and decisive action" from European leaders.[2] The week before, he advised them to "inject capital into weak banks" and "lay out a framework and a vision for a stronger Eurozone, including deeper collaboration on budgets and banking policy," while maintaining that "it is in everybody's interest for Greece to remain in the Eurozone."[3]

While these proscriptions have merit and may have worked at one time, they are no longer fiscally sufficient or politically feasible. Nor are they bold enough to provide Europe, its banks, and its lenders what they most need: certainty, finality, and the conditions for real economic reforms.

European Central Bank President Mario Draghi's recent remarks to Members of the Eu-

Peter Charles Choharis is an Adjunct Fellow at the American Security Project ropean Parliament—"Can the ECB fill the vacuum of lack of action by national governments on fiscal growth? The answer is no."—were more than just a rebuke of the EU's political leadership for failing to undertake structural changes.[4] They were also an admission that the ECB's monetary strategy of pumping money into banks so that they can continue to buy sovereign debt—a strategy seen as saving Europe a few months ago—has run its course.[5]

To date, the ECB has purchased €212 billion ($267 billion) of sovereign debt[6] and flooded European banks with more than €1 trillion ($1.26 trillion) of 1 percent loans.[7] But cutting the bench mark rate from the recently lowered 0.75 percent to 0.5 percent or less and buying more distressed debt will not work. [8]

Many economists believe that further monetary infusions are futile, given how much has already been pumped into Eurozone banks. And while borrowing is getting expensive--witness Spanish bonds at 7 percent--the problem is too much debt, not insufficient capital with which to purchase the bonds.[9]

As for purchasing more distressed sovereign bonds, the ECB's Charter prohibits it from buying sovereign debt directly and its balance sheet is already under stress from the falling value of its current holdings.

More fundamentally, at a certain point, it stops being possible to refinance banks, companies, and even countries that are beyond repair. Europe has reached that point.

Although Greece and Spain are dominating the news, this year Europe as a whole must reschedule €1.1 trillion ($1.38 trillion) of sovereign debt out of the $7.6 trillion debt of the world's major economies that must be refinanced this year.[10, 11] In addition, Standard & Poor's estimates that European companies must refinance more than $500 billion of corporate bonds this year, with $435 billion comprised of financial company debt.[12] European countries must refinance their debt even as many of them are having their credit ratings cut, their public debt-to-GDP rises, and many of their largest economies contract. To make matters worse, the combined pension fund obligations of nineteen EU countries are almost €30 trillion ($39.3 trillion).[13]

Meanwhile, a primary source of European credit—European banks—are themselves facing large capital shortages. As the value of their sovereign debt holdings continues to fall, they have had to boost the value of their assets to comply with new EU bank capitalization requirements.[14]

As a result, the Eurozone no longer has the credit or credibility to bailout Spain's banks and regional governments; restructure Greece's unsustainable workout of just a few months ago; continue helping Ireland and Portugal; bailout Cyprus and most likely Hungary; fend off attacks on Italy's €1.9 trillion of debt (the world's fourth-largest debt); and possibly aid Belgium—a list that will likely grow.[15]

To take only the first challenge, a client report by HSBC has estimated the cost of a full IMF/EU bailout of Spain to be approximately €450 billion over the next three years, of which $125 billion (€100 billion) would be allocated to Spanish banks.[16] But the current lending ability of the European Financial Stability Facility amounts to only €440 billion, with some monies not available until 2014, despite being backed by guarantee commitments of €780 billion.[17]

A permanent bailout facility, the European Stability Mechanism (ESM), will eventually hold a €500 billion, but the facility must first be ratified by all 17 Eurozone governments.[18] Now that Spain is a bailout recipient, France, Germany, Italy, and others must bear a bigger share—even as France and Italy are themselves under fiscal pressure.

Even with the International Monetary Fund's help, there is not much of a margin to tackle the rest of Europe's problems should the contagion spread, as it likely will. And with China's economy slowing and the U.S. economy sputtering, there is no prospect of outside money to refinance the Eurozone's ailing public and private institutions or to jumpstart Europe's economy, whose countries are entering a recession or worse.

Nor is it clear that the recent bailouts of Spanish banks will abate Europe's financial contagion, since the €386 billion ($480 billion) in total bailouts to Greece, Ireland, and Portugal did not avert Spain's troubles.[19] Given the U.S. experience after its banks were bailed out, it is also unclear that Spanish banks will now start lending to private businesses and spur Spain's economy. And Spain's bank bailout has already resulted in higher sovereign interest rates, since it has yet more debt on its books.

While some have called for greater governmental integration and fiscal unity through Eurobonds or Eurozone debt guarantees under the supervision of a new EU banking commissioner, the political time for these measures may have passed.

For after months of telling their citizens that the periphery countries like Greece and Portugal caused their own financial woes through profligate spending, and as the need for bailouts spreads and the costs mount, leaders of northern countries like Germany and Finland cannot muster the political support to assume the financial risk of the periphery's sovereign debt. And without substantial new lending and perhaps outright aid from the north, it is difficult to see how the periphery countries will get the capital needed to stimulate their economies.

Conversely, after months and in some cases years of high unemployment and recession, citizens of periphery countries like Spain and Greece are rebelling as their governments arrange hundreds of billions in bank bailouts while slashing education and health care.

This popular backlash has spread to Italy, France, and even the Netherlands and much of Germany, making it impossible for governments to adopt the conditions necessary for greater fiscal unity and integration—namely, surrendering more national sovereignty to discredited EU institutions and enduring more fiscal discipline in the form of higher taxes and slashed government spending.[20] Indeed, Britain has already rejected a unified banking supervisor[21] and a banking union to pool European bank deposit risk and coordinate bailouts also seems dubious.[22]

The result is that the world's largest economic area is frozen, with no fiscally or politically viable options to spur economic growth and no institutions to impose any.[23] Put another way, the Eurozone is integrated enough for contagions to spread but not for solutions to be enforced. As the IMF recently observed: "The euro area is in an uncomfortable and unsustainable halfway point. While it is sufficiently integrated to allow escalating problems in one country to spill over to others, it lacks the economic flexibility or policy tools to deal with these spillovers."[24]

New Institutional Frameworks

Rather than advocating greater fiscal unity and bank bailouts, the United States can help Europe most by promoting two new institutional frameworks that foster finality and reform, so that European nations can resume borrowing from international capital markets at affordable rates.

1. Eurozone Exit

For months, Spaniards, Italians, and other Euro depositors have been leaving the southern Eurozone. They have done so by transferring their Euro deposits to the safe havens of northern banks because they fear the loss to their savings if their Euros are converted to liras or some other future, deeply discounted national currency.

While precise statistics are difficult to obtain, *Bloomberg View* estimates that Spanish, Italian, and other periphery depositors have transferred €789 billion ($994 billion) to banks in Germany, the Netherlands, and Luxembourg—a trend that is intensifying.[25] Thus, while Greek, Spanish, and other periphery governments borrow hundreds of billions to recapitalize their failing banks—loans that add to their sovereign debt and for which their taxpayers are responsible—their depositors are depleting the same banks' reserves by shifting currency abroad.

Irrespective of whether or not the new Greek government can convince the ECB- European Commission-IMF troika to modify its bailout terms, Greece, and possibly Spain and others, will likely have to leave the Eurozone.[26, 27]

For the economies of the periphery are caught in a debt spiral that no amount of modified austerity will ease.

At the least, these countries—and the Eurozone as a whole—should have the option.

Leaving the Eurozone would immediately allow countries to devalue their currencies, lower labor costs, and make the costs of their goods and services more competitive. Although the cost of borrowing would rise in the short-term, that would force countries like Greece to improve its tax system even as the tax base expands from higher exports and economic growth.

Less than four years after Iceland's economy cratered, it is now enjoying 2.4% growth while its European neighbors are struggling.[28] Because it is not in the Eurozone, Iceland was able to halve its currency value, institute capital controls, and implement other measures that Eurozone members cannot.[29] Argentina and Russia similarly enjoyed robust growth after defaulting on their debts and devaluing their currencies a decade ago.[30]

The challenge for the Eurozone is to construct an equitable, transparent, predictable, and speedy transition procedure that would minimize risk not only to the exiting countries but to the region as a whole.

The ECB, European Commission, and others have reportedly begun planning for a Greek exit, including technical measures to avert market panic and prevent a run on banks, stabilize the new currency, and control capital flight.[31]

In addition, the procedure by which Greece leaves the Eurozone must provide a template for other countries, so that citizens and creditors alike can understand the potential risks, costs, and benefits and so that all Europeans are treated equally.

2. Sovereign Bankruptcy

The United States can also help establish a sovereign default facility under the auspices of the IMF to allow countries like Greece that are plagued by insurmountable debt a chance to recover.

Sovereign bankruptcy is not like a corporate liquidation in that there would be no provision for selling off all of a country's assets and distributing the proceeds to creditors. And sovereign bankruptcy proceedings could only be brought voluntarily by countries—not by creditors. But sovereign bankruptcy would allow public, transparent, legal procedures to govern; instead of the secret, protracted, private negotiations that have been the hallmarks of prior EU bailouts and that have resulted in *ad hoc* deals with no final resolution.

These proceedings would also include a range of interested parties, balance public and private interests, follow due process, and yield final results.

Bankruptcy would also allow a country's economy to recover quickly, end the need for future bailouts, limit the risk of regional contagion, and force creditors to bear at least part of the cost of imprudent lending.

It would also force citizens to pay more "taxes" in the form of higher public and private borrowing costs, at least in the short term, because of their nation's prior unsustainable borrowing and spending. Court proceedings could also expose the reasons for the country's bankruptcy, thereby helping to promote accountability and avert similar behavior in other countries.

While a full-fledged international judicial mechanism will take time to design and implement, the United States can play the role of an honest broker outside of the EU to shape and potentially administer an expedited bankruptcy process, perhaps based on Chapter 9 of the U.S. Bankruptcy Code that governs municipal bankruptcies like Alabama's Jefferson County.[32]

Mechanisms to enable countries to exit the Eurozone and declare bankruptcy, whether individually or in tandem, may result in significant economic and social dislocations.

Estimates for the cost of a Greek exit from the Eurozone alone range from €150 billion ($189 billion) to €1 trillion ($12.6 trillion), though German and French finance officials estimate it would cost them a manageable 3% of their GDPs.[33, 34] And unlike the Lehman collapse that shocked international capital markets,[35] financial institutions have been adjusting their exposure to periphery countries for months.[36] "Greece is not a big deal in itself. It's not a major risk," observed Francois Baroin, France's former finance minister.[37]

But any cost must be weighed against the cost of indefinite bailouts. Not only have four bailouts not stopped Europe's debt crisis from spreading—Italy's debt is now under assault[38]—but they have driven the four countries into greater debt with little or no improvement in growth or employment. And far from providing the confidence necessary for investment and economic expansion, they have left half a billion Europeans deeply skeptical of their own governments and EU institutions.

Better to use limited funds to mitigate the short-term economic and social hardships that may result from countries exiting the Eurozone and declaring bankruptcy, than to deplete those funds and watch the contagion spread.

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Building a New American Arsenal

The American Security Project (ASP) is a nonpartisan initiative to educate the American public about the changing nature of national security in the 21st century.

Gone are the days when a nation's strength could be measured by bombers and battleships. Security in this new era requires a New American Arsenal harnessing all of America's strengths: the force of our diplomacy; the might of our military; the vigor of our economy; and the power of our ideals.

We believe that America must lead other nations in the pursuit of our common goals and shared security. We must confront international challenges with all the tools at our disposal. We must address emerging problems before they become security crises. And to do this, we must forge a new bipartisan consensus at home.

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