

## Why the super-Marios need help

Martin Wolf, *Financial Times*, January 17, 2012

Will the two Marios – Mario Monti, the new technocratic prime minister of Italy, and Mario Draghi, the still quite new president of the European Central Bank – save the eurozone? No. But individuals can make a difference. These men bring sophisticated pragmatism to the table. Without that, this flawed structure will not survive. Policymakers must be both more co-operative and more flexible. The economic and political costs of a breakdown would be so large that one has to hope for better. Maybe the two Marios will shift policy in a more productive direction.

The first is the new long-term refinancing operation, announced by the ECB last month. With banks under fierce funding pressures, the offer of three-year money at the average of the ECB's benchmark rate (today 1 per cent), without stigma, was one the eurozone's banks could not refuse. Initial take-up was €489bn for 523 banks. The balance sheet of the ECB is about to explode. This was a bold and cunning move by Mr Draghi and probably the most he could get away with right now.

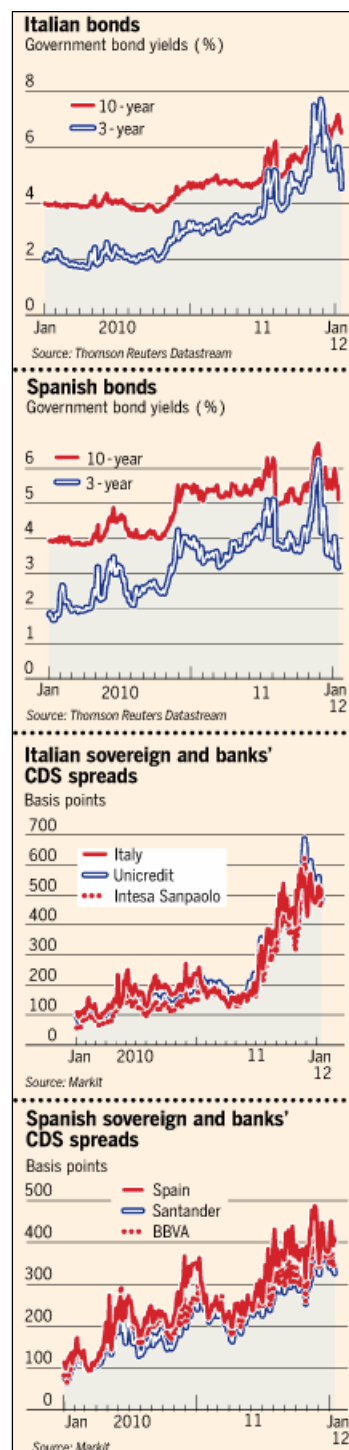
Cheap longer-term central-bank funding should help stabilise the eurozone financial system. Whether it will also stabilise sovereign debt markets is far less clear. Most European banks are likely to resist purchasing the debt of riskier sovereigns, given the pressure from the European Banking Authority to raise the capital they hold. But the domestic banks might make different decisions, probably under pressure. That would help fund vulnerable governments, but also increase the concentration of risk in domestic banks. This is high: in mid-2011, 28 per cent of Spanish debt and 27 per cent of Italian debt was held by domestic banks, according to a paper by Jean Pisani-Ferry for Bruegel, a Brussels-based think-tank.\*

A second straw is the willingness of Mario Monti to argue, in an interview with the *Financial Times*, for creditor countries to do more to lower his country's borrowing costs, even warning there would be a "powerful backlash" among voters in the periphery if they did not. Mr Monti is in a strong position to make this argument. If not him, who? If not now, when? He is a well-respected official with staunchly pro-European views and a strong sympathy for German attitudes to competition and fiscal and monetary stability. Upon his success is likely to depend the survival of the euro, at least in its current form. His failure would surely bring the deluge.

Messrs Draghi and Monti are addressing two interlinked fragilities: the vulnerability of the banking system and the unsustainable terms on which weaker countries can now borrow (see chart). But they cannot resolve these difficulties. For that more radicalism is required than either can deliver, on his own.

The paper by Mr Pisani-Ferry and another one co-authored by Paul de Grauwe of the university of Leuven\*\* indicate the deeper problems to be addressed. The former argues that the debate on reform focuses on fiscal discipline even though failure to abide by these fiscal rules played a small part in causing today's crisis. The irresponsible behaviour of private lenders and, in many cases, private borrowers was as important. What needs to be understood, both papers suggest, is the fragility of the eurozone as a structure, in three interlinked respects: the lack of any joint responsibility for public debt; the absence of monetary support for sovereign borrowing, even in a severe crisis; and the close connection between sovereigns and domestic banks (see chart).

What is striking about risk spreads on eurozone sovereign debt is that they are not matched by those on the sovereign debt of high-income countries with their own central banks, such as the UK, even though their deficits or debts are sometimes higher than those of comparable eurozone members.



That is why France is understandably irritated by its rating downgrade, while the UK remains (for the moment) at triple A. Investors in what have become “sub-sovereign” debts face a liquidity risk, which might bite them at any time.

Such enhanced vulnerability to financial and sovereign debt crises is not the only threat to the weaker members of the eurozone. They also confront a bigger adjustment task than do countries with flexible exchange rates. The danger, however, is that the severity of the financial crises members suffer deprives them of the time they need to secure changes in competitiveness. In Italy’s case, for example, the combination of high interest rates and vulnerable banks with fiscal austerity is likely to lead to a lengthy and deep recession and so to a rise in cyclical fiscal deficits as the structural deficit falls. For a big country to deflate its way to health, in these circumstances, is a labour of Sisyphus. No modern democracy has infinite patience. Markets know this and will react accordingly.

Mr Pisani-Ferry argues that several possible reforms do exist: a move to genuine federal oversight and backstop for banks; reform of the ECB, to make it a modern central bank; or something closer to fiscal federalism. All of these create huge difficulties. None of these is likely to be agreed. But it is hard to see any escape from the crisis and move to something more stable without some such changes. If the status quo fails and break-up is ruled out, one must choose reforms, however painful.

If we ask why the needed changes are quite so difficult, the answers are probably threefold. First, this project was a bet on how “European” citizens of member states would feel. The answer, so far, is “not enough” and perhaps even “less and less”. Second, the project was a bet on the ability to agree on a shared diagnosis and workable solutions in a crisis. These have been lacking, so far. Finally, the project was also a bet that, come the crisis, leadership would be forthcoming. Again, we are still waiting for the necessary vision.

Yet the costs of failure are so large that the possibility of domestic and eurozone reform must be kept alive. Mr Draghi’s leadership of the ECB can help do that. Meanwhile, Mr Monti is in a position to cajole other members, including the Germans, towards reforms. He can speak truth to the power of the creditors. The latter should listen attentively.

\* Jean Pisani-Ferry, “[The Euro Crisis and the New Impossible Trinity](#)”, Bruegel, January 2012.

\*\* Paul De Grauwe and Yuemei Ji, “[Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone](#)”, January 2012.