ASIA IN THE NEW GLOBAL FINANCIAL SCENE

"The Euro Area Crisis – Quo Vadis?"

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I have been asked to address recent developments and prospects in the euro area crisis. In all honesty, however, no one knows with any degree of certainty where the euro area crisis is heading. Predicting developments in Europe has always been difficult for an economist, because politics need to be factored into the equation. It is *politics* that have dominated euro area crisis management, and it is *politics* that will ultimately decide the fate of EMU.

But one thing is clear: while the smooth functioning of monetary union clearly requires further integration ("more Europe"), and the crisis has pushed EU leaders in this direction, the same crisis has also turned public opinion against this very process – be it due to adjustment fatigue in the periphery or to bail-out fatigue in the core. The real risk, which is indeed playing out, is that the strains in this process are diluting the political glue that has kept the euro edifice together.

The question on everybody's mind is of course Greece. But the real, underlying question is, rather, can the euro zone effectively ring-fence Greece and arrest the contagion to other weak peripherals? EU leaders are arguing that the euro area is now much better placed in this area than it was some months ago, with notably larger firewalls having been agreed. But the reality is less promising, on two counts.

First, the EU firewalls are *not* larger. The permanent mechanism, the European Stability Mechanism (ESM), set to start operations in July 2012, has always had a lending cap of €500 billion. This remains unchanged: fresh lending capacity remains fixed at €500 billion – not a euro more.

Second, and more seriously, even the touted €500 billion is not readily available from the start. Its mobilization would require moving quickly to increase the ESM's paid-in capital. This is because the ESM Treaty stipulates that paid-in capital has to be at least 15% of outstanding loans. Thus, given the phased injection of capital, the ESM's lending capacity is effectively constrained to no more than €107 billion at the start of operations. True, it has been agreed that this can be complemented (until July 2013) by tapping the unused funds of the

[1] Summary of intervention.

EFSF (equal to €248 billion). But even using these funds, the total available as from July 2012 is only around €350 billion, and would actually decline to €320 billion in July 2013, when the EFSF winds up operations and its unused funds are no longer available. So, the full potential of the €500 billion is only reached two years from now, in early 2014, unless the schedule for paid-in capital is accelerated further.

But, even if the full firepower of the agreed firewalls could be deployed rapidly, the risk that will need to be countered goes beyond their capabilities. The risk at hand it is that of a possible full-fledged bank run in some of the periphery countries and, to counter that, the only real defense would be that of unlimited ECB action. Indeed, if a bank run were to develop in other countries, unlimited ECB action to shore up the eurozone banking system appears likely, whatever the philosophical or legal objections – a disorderly break-up of the euro project is likely in the end to be too disturbing to contemplate for all.

Would there be a more orderly way out? Yes: it would consist in a re-balancing of the policy mix followed in Europe, with notably a re-profiling of the crisis countries' adjustment path and the use of fiscal space by countries that enjoy it, accompanied by sizable investments financed via jointly guaranteed project bonds and the EIB, as well as real progress with respect to EU-wide financial supervision and bank resolution arrangements.

Is any of this politically feasible? Not easy, but the opportunity may be provided by plans to complement the fiscal pact with a "growth pact," as proposed by France's new President Francois Hollande, and supported also by Italy's Mario Monti, ECB President Mario Draghi, and the EU Commission and EU Parliament. This is a non-negligible array of forces, which seems to have affected the German position as well. Still, time is frighteningly short and may well be running out.

Lest I be misunderstood, let me clearly state that none of this means that Greece can avoid austerity: even if it walks away and repudiates all debt, it will still be unable to cover its domestic commitments, given the persistence of a primary deficit. In a nutshell, Greece can *vote* against austerity but it cannot avoid it. The issue is: does the dose of austerity really have to amount to 5.5% of GDP to be specified by June of this year and implemented in two installments, the first in 2013, the second in 2014, as envisaged under the bail-out agreement? Not only is this unlikely, but is it necessary?

Even if all of this falls into place, saving the single currency itself will require more. The ingredients are well-known, and consist essentially in full-fledged fiscal federalism or fiscal union – recently again called for by many eminent Europeans – but which remains beyond the politically feasible at this time. Until then, the awareness – now embedded in the market – that the euro remains a composite currency will continue to draw attention to its weakest link at any point in time, raising questions as to whether it will be able to continue to be a member. This is not a situation that can be sustained for long. The unanswerable question is what gives: will it be opposition to fiscal union or the continuance of EMU as we know it?

In closing, let me add that it is important that Asia avoid Europe's mistakes: by (a) awareness that regionalism is helpful but can have its limits since, in situations of highly correlated risks, linkages fuel the fire and affect the effectiveness of self-insurance; (b) the need for working arrangements that avoid too many crisis managers (nothing similar to a "troika"); (c) ensuring certainty and speed of interventions; (d) avoiding excess politicization of crisis management; and (e) advancing multilateral solutions: not only via robust global financial safety nets, but also by reviving consideration of a sovereign debt restructuring mechanism, which the world continues to need.