FINANCIAL TIMES

June 25th 2012

How to shift Germany out of 'can't do' mode

At a meeting in Rome last Thursday, the heads of state of Germany, France, Spain and Italy agreed on steps towards a banking union and a modest stimulus package to complement the fiscal compact. But Angela Merkel resisted all proposals to provide relief to Spain and Italy from the excessive risk premiums prevailing in the market. This threatens to turn the EU summit this week into a fiasco that may well prove fatal because it will leave the rest of the eurozone without a strong enough firewall to protect it against the possibility of a Greek exit.

Even if a fatal accident can be avoided, the division between creditor and debtor countries will be reinforced and the "periphery" countries will have no chance to regain competitiveness because the playing field is tilted against them. This may serve Germany's narrow self-interest but it will create a very different Europe from the open society that fired people's imaginations. It will make Germany the centre of an empire and put the "periphery" into a permanently subordinated position. That is not what Ms Merkel or the majority of Germans stand for.

Ms Merkel argued that it is against the rules to use the European Central Bank to solve the fiscal problems of member countries – and she is right. ECB president Mario Draghi has said as much. There is a missing element in the current plans for the summit: a European Fiscal Authority that, in partnership with the ECB, could do what the ECB cannot do on its own. It could establish a debt reduction fund – a modified form of the European debt redemption fund that was proposed by Ms Merkel's council of economic advisers. In return for Italy and Spain undertaking specified structural reforms, the fund would acquire and hold a significant portion of their outstanding stock of debt.

It would finance the purchases by issuing European Treasury bills and pass on the benefit of cheap financing to the countries concerned. The bills would be assigned a zero-risk rating by the authorities and would be treated as the highest quality collateral for repo operations at the ECB. The banking system has an urgent need for risk-free liquid assets. Banks hold more than €700bn of surplus liquidity at the ECB earning only 0.25 per cent interest. This assures a large and ready market for the bills at 1 per cent or less.

Should a participating country subsequently fail to live up to its commitments, the EFA could impose a fine or other form of penalty that would be proportionate to the violation so that it would not turn into a nuclear option that cannot be exercised. This would provide strong protection against moral hazard. For instance, it would make it practically impossible for a successor government in Italy to break any commitments undertaken by the Monti government. Having practically half the Italian debt financed by European Treasury bills would have an effect similar to a reduction in the average maturity of its debt. That would make a successor government all the more responsive to any punishment imposed by the EFA.

After a suitable period the participating countries would enter into debt reduction programmes that would be tailored not to jeopardise their growth. That would be the prelude to the establishment of a full political union and the introduction of eurobonds. The issuance of European Treasury bills would of course require the approval of the Bundestag but it would be in conformity with the requirement by the German constitutional court that any commitment approved by the Bundestag should be limited in time and size.

It is not too late to turn in a political declaration that outlines not only the long-term goal of a political union but also a road map towards a fiscal and banking union. Guided by this declaration, the European Financial Stability Facility could immediately take over the ECB holdings of Greek bonds, the ECB could start accumulating Spanish and Italian bonds, and Italy and Spain could implement the structural reforms that would qualify them for the debt redemption fund.

This would have the same effect on markets as the finance ministers' declaration in November 2009 that saved the financial system. It would also change the political dynamics.

The main obstacle is in German politics, which is mired in a "can't do" mode. Ms Merkel insists that a political union should precede a fully fledged fiscal and banking union. That is both unrealistic and unreasonable. The three have to be developed together, step by step.

There can be no treaty or constitutional clause preventing the establishment of the EFA if the German electorate as represented by the Bundestag approves it – otherwise there could have been no European Stability Mechanism. If the rest of Europe is united behind this proposal and the Bundestag rejects it, Germany must take full responsibility for the financial and political consequences.

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