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'THE CONVERGENCE ILLUSION': WHY EUROPE'S APPROACH TO THE FINANCIAL CRISIS ISN'T WORKING – AND WHAT TO DO ABOUT IT

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'The Convergence Illusion': Why Europe's Approach to the Financial Crisis Isn't Working – and What to Do About It

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Abstract

The crisis of sovereign debt in Europe revealed the limits and anomalies of the Euro, the common currency for 17 European Union member states, which participate in the EU common market but are denied independent monetary policies, even during a period of severe economic contraction and illiquidity. Such rigidity has had some perverse effects, such as, in the wake of divergent pressure on interest rates, that capital flight from weak to strong countries, exacerbating political differences within the EU, even to the point of calling the Union's continued existence into question.

The solution to the sovereign debt crisis and the restoration of confidence in the European project are critical for the long term stability and economic growth of the region, and for the stability of worldwide financial market. But such a solution lies not only in Eurozone members' hands, rather, particularly in this moment, in US possible support and long term strategy. The opening to a renewed Transatlantic bond, eventually extended to a broader common market or at least a trade agreement, jointly with a clear path to a growing political integration of Europe may be the ways for solving credibly all market doubts on the future of Euro and the stability of financial markets.

Reversing the most serious adverse trends – as opposed to temporizing with 'crisis response' – requires a thorough understanding of the origins of the crisis and the continuing efforts to contain it, in Greece, including the prospects for stemming contagion to Spain and Italy. This paper explores those issues and, as well, the continuing political difficulties that plague European policy making. The implications for the US economy and global financial stability of continuing failure by Europe to confront difficult truths -- and to take concerted action -- are enormous.

Keywords: Convergence, Economic Growth, Globalization, Growth, US, EU.

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The anomalies of Euro and the 'Convergence Illusion'

When the Euro was devised in April 1998 (and then circulated as a paper bill as of January 1st, 2002), it seemed as if the entire European project had taken a giant, irreversible leap forward. The immediate task for the single currency was to supplant the role of the Deutsche Mark, the benchmark currency known for its strength and stability. And this core aim was achieved. The Euro became the reference currency for much of Europe.

However, as we now know, the Euro indeed represented a giant leap, not just towards inexorable European integration, but, rather, into a world of financial make-believe. Driven by political considerations, the architecture for the Euro turned out to be as imaginary as the bridges and buildings that are fictional decorations for the paper currency itself.

The architects behind the currency are perhaps better thought of as 'visionaries' since the entire project rested, truly, on a common 'vision' – in the sense that Joan of Arc had a vision more than, say, Jean Monnet. They understood that, at its essence, a national currency is a storehouse of value that, on the open market, reflects the strength or weakness of a given economy, as well as its trade balance and the sum of its fiscal and monetary policies. What they did not understand (or, more accurately, pretended not to understand) is that a common currency comprising highly variegated economies could not survive without the institutions to constrain (or at least compensate for) substantial and systematic differences in fiscal and monetary policy as well as in macroeconomic performance.

Instead, the Euro's visionaries invested in what we can call, 'the convergence illusion.' This is the theory under which the Euro would automatically force member countries to converge economically, by *de facto* neutralizing economic policy leverage for governments. The thinking was that having a commonly valued currency would somehow over time force governments to cohere fiscal policy. Markets implicitly accepted the convergence theory and sovereign spreads between Eurozone countries were, in fact, quite limited for a decade. In reality, the convergence magic did not materialize. Instead, several weak Eurozone countries have run unsustainable deficits and/or failed to make structural reforms that would have make convergence sustainable. The result has been unending crisis.

The 'visionaries' would point out that Eurozone members also pledged, under the 'European Stability Pact' to keep deficits within a narrow range of GDP. Alas, these overoptimistical theorists seem not to have contemplated that anyone would violate these pledges, as sanctions were only optional. In reality, sanctions have never been imposed for those who violated their pledge. Violations soon became tolerated and therefore, widespread. Even the relatively parsimonious Germans have flouted these rules.

In recognition of the failure of the Stability Pact, 25 of 27 EU countries, including all Eurozone countries, agreed in March, 2012, agreed to a new "fiscal compact" that would force those countries with a debt to GdP ratio above 60% to arrive to a structural deficit of maximum 0.5% and to bring back the debt/GdP ratio to 60% within 20 years. Despite the long time-frame, even this revised mechanism will prove challenging to achieve. One of Europe's largest economies, Italy, for example, currently has a debt to GdP ratio of 126%, requiring the imposition of severe austerity with little prospects for growth.

The Euro is a reference currency which has no single Treasury behind it, which is another visionary flight of fancy. This means there is no single governmental entity to monitor the impact of government policy on exchange rate stability. Instead, the Euro relies on a Central Bank with no mandate for autonomous economic policy. The ECB is anchored to a defined inflation target, and its monetary instruments are narrowly constrained by treaty, confining it to the role of ensuring the stability of the system rather than an instrument of economic support through monetary policy (like the Fed). Fiscal policy in Europe is left up wholly to national governments leaving Brussels with no say whatsoever.

Sustainability of the Euro also depends on maintaining balanced competitiveness of all countries in the Eurozone. In theory, in a single currency area comprising several states, rising unit labor costs in a country would lead to a decline in exports, and therefore, a decline in economic output. Unfortunately, here the theory has worked too well; chained to a common, strong currency, underperforming Eurozone economies can no longer achieve trade balance by simply allow their currencies to cheapen on international markets. At the same time, with a single, strong currency supporting commerce in both strong and weak economies, imports of value added products from strong countries like Germany have remained artificially high, further aggravating trade imbalances in less competitive Eurozone countries.

The burden of past public debt and inefficiencies would have been a major impediment to launching the Euro, but only if the market had priced legacy debt appropriately. Instead, the market simply bought into the "convergence illusion" from 1998 to 2008, accepting intuitively that a common currency would impose common competitiveness and, thereby, common fiscal discipline. Likewise, holders of Greek and similar sovereign debt, similar in their behavior to purchasers of US sub-prime mortgage derivatives, simply assumed that European growth would continue inexorably, facilitating convergence and making the debt burden manageable even in higher debt economies.

In turn, the belief in convergence kept borrowing spreads quite narrow, limited to a few basis points (the 10-yrs difference between Germany and Greece was in the area of 25-30 bps). The borrowing honeymoon was sustained with another seductive theory: that all Eurozone member states would only need a bit of time and some resources to adjust their inefficiencies and manage imbalances in public finances. While Germany embarked on difficult structural reforms in the early 2000s, other Eurozone members squandered the adjustment period, failing to make any dent on state obligations to pensioners or seriously addressing structural costs. For years, national budgets simply continued on a path unsustainable in the long run, without significant effort to reduce labor costs or increase labor flexibility and mobility. In short, the Euro was a currency launched without an adequate institutional foundation, the policy superstructure or the political commitment to sustain its value.

1. The crisis and its effects

The failure of Lehman Brothers in 2008 ignited the financial crisis by generating a chain reaction of near-panic as creditors suddenly were left wondering what the value of debt on their books really was. Lehman, and the related subprime crisis in the US, triggered a financial crisis from which Europe (unlike the US) has not begun to recover.

European governments, like the US, had to intervene urgently to support the banking system, but this move simply opened another facet to the Euro crisis. From the outset, instead of acting in concert and continuing on the path of greater financial and political union, each Eurozone member tended to support its ‘own’ banks. Support for banks since then has remained a mostly national, uncoordinated and spasmodic emergency activity (utilizing different tools, such as a state guarantee in Germany and state-funded capital increases in the UK and other states.)

With few exceptions, the aim of emergency response has been to put out the fire in one state, without regard to the flames licking the rickety frames of other countries’ banks. This ‘beggar my neighbor’s bank’-policy made it painfully clear to the market that when it came to risk there was, in fact, no ‘Union’ at all, but rather a highly variegated conglomeration of EU countries. This also resulted in the end of the convergence illusion, as markets now priced in national risks as opposed to Europe-wide or the Eurozone as a whole.

To cope with the acute recession in 2009 that followed the financial crisis, Eurozone countries let public deficits grow. This led to a generalized pressure on public debt costs, particularly in the weak countries (the “PIGS”), underscoring the notion that there was no “Eurozone” risk at all, but rather individual sovereign debt risks. The eventual default of a sovereign Eurozone borrower was no longer an unthinkable event.

As bond holders increasingly ‘thought about the unthinkable,’ spreads suddenly began to rise between those heavily burdened with sovereign debt and those less indebted. This has led to a new vicious circle, where the debtor country, punished by the market, has had to make restrictive economic reforms and raise taxes to cope with balance sheet imperatives, so that it can attempt to restore its “credibility” as a sound borrower. But embracing austerity has stunted growth, aggravating the recession, resulting in further punishment from bond markets, with even higher spreads. In turn, higher spreads trigger more restrictive measures and then a deeper crisis. In short, austerity, contrary to its very purpose, has generally failed to bring down spreads, or where it has, has failed to do so commensurate with the associated drop in economic activity.

Higher spreads and fear of sovereign defaults also led to another perverse effect, which is that substantive financial and investment capital flows started to go from weak to strong countries of Eurozone further aggravating the disparity between Eurozone economies by providing access to lower cost financing to industry in northern Europe while frequently penalizing industry with higher interest rates in southern, indebted economies. This may suggest that normal self-equilibrating dynamics which should characterize a well (economically) integrated are not functioning in the Eurozone. Such imbalances also favored speculative allocations with shorter term horizon rather than productive investment and growth, implying that Europe is still far from being perceived as economically integrated.

In sum, the assumed process of convergence instead became “divergence.” Richer Eurozone states benefited from the crisis as the single currency prevented any competitive devaluation, sustaining their high value exports, while continuing to afford them access to the bond market at favorable rates. Meanwhile, the exact contrary was happening in the weak economies, as they entered the vicious circle of fear and austerity leading not to

confidence, but more fear. Divergence has had a political dimension as well, with richer, Northern countries sneering at their 'lazy, profligate' Southern neighbors, further sapping the cohesion necessary to make far reaching political reforms that are, ultimately, the only salvation for the Eurozone. As Hughes-Hallett and Martinez Oliva suggest, "the European crisis should perhaps be seen as collateral damage from political disagreements over the real purpose of EMU and European integration.'[1].

2. Relevance of the Greek case

The *coup de grace* has been reached in Greece, where the country's 'brand' has become so tarnished that even productive Greek enterprises are now penalized by lenders with higher interest rates. The problem has become so acute that some of Greece's largest and most profitable companies are re-locating, further damaging the country's prospects for recovery.

Greece, of course, is where the sovereign debt crisis first exploded. The weaknesses of the Greek economy were concealed by artful maintenance of public finance accounts aimed at satisfying pre-Euro convergence criteria. The actions taken so far by EU, ECB, IMF ('the troika') and other major players have not afforded a decisive solution to Greece's problems, rather they have been temporary crisis-aversion measures. The troika's policies have mostly been based on over-optimistic scenarios about the ability of the Greek economy to recover, fueling overly optimistic assessments of the sustainability of its public debt burden.

Since the onset of the crisis (2009), the 'troika' has been unable to devise a comprehensive plan to address the Greek crisis. This lack of a conclusive solution has left markets with the impression that the only strategy is, in fact, just to buy time so that European banks (heavily exposed to Greek debt), would avoid the onslaught that would be triggered by a sudden default. To date, the total nominal cost of bailouts and "haircuts" to support Greece is well over 300 billion in Euros.

So what has been won with this staggering cash infusion and debt relief? To date, Greece has failed to get on a sustainable path. Although the yawning budget deficit has closed, and unit labor costs have gone down, fundamentally, there is still lack of confidence of the sustainability of Greece's debt burden. Austerity and the lack of liquidity continue to depress output, fueling speculation that, in the end, Greece might yet exit the Euro. Once-optimistic forecasts about recovery and long term sustainability of the restructured debt have not been fulfilled. Instead, Greece continues in recession, now lasting over four years and expected to continue.

The continuing bailouts in Greece have been far more costly than a prompt, effective intervention in 2009-10 (when German electoral issues prevented more concerted action). The case of Ireland is illustrative. In Ireland the crisis was mainly the result of the banking sector. But Ireland attracted the intervention of the United Kingdom (which is not a

[1] See Andrew Hughes-Hallett and Juan Carlos Martinez Oliva, "The Importance of Trade and Capital Imbalances in the European Debt Crisis", January 2013.

Eurozone member) which saw its own national interests at stake. By contrast, French and German interests in Greece have been reflected by onerous austerity measures.

On 13th December 2012, EU finance ministers approved another bailout of EURO 49.1b to Greece to inject new funds and in part as forgiveness packages on interest for existing bailout debts. The decision came after Greece bought back, at a heavy discount, EURO 31.9b of its bonds. Both EU and Greek leaders have celebrated this decision, claiming it vindicates the current policy and proves that indeed solidarity, not 'go it alone', is the dominant trend in Europe. The celebrations are premature because the bulk of the package had already been agreed to and had been suspended pending enactment of reforms by Greece. Moreover, the package includes stretching out some targets for debt to GdP ratio (still a daunting 120%) to be reached by Greece only by 2022. Even in the wake of the jubilant announcements there are voices claiming that the only "final" way out of the Greek crisis is substantial debt forgiveness (which is hard to negotiate and will be difficult for creditor countries to accept, in part because it will create a dangerous precedent in other cases.)

Indeed, given the continuing tenuousness of the situation, and the lack of a convincing strategy (or even the concerted political will to devise one), there is still the temptation to pursue a 'managed' Greek exit from the Euro as a panacea. Unfortunately, the architecture of the Eurozone makes such an exit practically impossible as the treaty did not define any mechanism to accomplish such a step. Adopting the Euro was meant to be an irreversible step, just as forward movement on continued European integration was thought to be irreversible. In addition, even if a mechanical means existed for Greece to exit the Euro, no credible financial means have yet been devised to arrest contagion (the anticipated panic that would ensue as banks which have substantial exposure to Greek debt -- and even banks that don't -- face anxious depositors and creditors who will doubt the solvency of these institutions.)

To create an exit mechanism now would therefore incur severe risk. For a weak country whose currency is expected to sharply devaluate after the exit, one can anticipate sudden outflows of money or (private and public) defaults. Paradoxically, the only countries that could manage an exit are the strong ones -- whose export-oriented economies benefit from the Euro and whose economies would eventually suffer from a higher value, non-Euro currency. In short, rich and poor, indebted and parsimonious, bloated and reformed, Eurozone countries are now tethered to one another.

3. **The "irreversible" currency and clashing interests in the EU**

At each critical moment of the current crisis, it may have appeared that Europeans have stepped up and done what was necessary to avert collapse. However, the measures taken have served mainly to stave off collapse for a short period, leaving markets unconvinced of the sustainability of current debt burdens. The most recent example is the 14 December EU Summit decision to place the Eurozone's biggest banks under ECB supervision. While a significant step forward, the agreement still awaits approval by European parliaments. More to the point, European leaders left other steps unaddressed such as providing the ECB with the ability to insure public deposits and to dissolve or resuscitate failing banks. Leadership has been glaringly absent, as difficult decisions only seem to come when politicians are

faced with the abyss; indeed, the lack of ambition at the 14 December Summit was due precisely to the fact that the immediate pressure on the Euro seemed be easing.

Complicating resolution of the problem is the fact that the central players (Germany on the political side, and the ECB, as the central bank, with all the limits of its mandate) cannot assuage market anxiety with finality by proclaiming their intention to always and unconditionally come to the Euro's rescue. If they do so, they incur moral hazard of relieving pressure on (and thereby leverage for) leaders in debtor countries to commit and achieve painful economic reforms to their publics, which, in fact, have only been partially sold. Unfortunately, markets are much less forgiving when it comes to the logic of moral hazard; the less clear and express the commitment of the 'troika' (the EU, the ECB, and the IMF) to defending the Euro, the more bearish and jittery markets remain.

As for the ECB, unlike the US Federal Reserve, it has strict constraints under its governing treaty and therefore cannot conduct quantitative easing operations that are an antidote to disinflation. The ECB instead tried a surrogate, the two LTRO ("Long-term refinancing operations", up to three years liquidity supply to Eurozone banks for a total of around Euro 1 trillion) deals for the commercial banking sector in December 2011 and February 2012. This approach has also proven, to be only of temporary relief. Subsequent announcements by the ECB about its readiness to back a "non-reversible" Euro, including by its President Mario Draghi have been made, but the markets do not seem to be completely convinced. Recent reduced pressure on Euro seems more the consequence of concerns for US problems (fiscal cliff, debt ceiling) than the buying of a new phase achievement.

In general, interventions in nearly all cases have not been timely, not been well coordinated and, therefore, in the end, were more costly. The two stability mechanisms created (the European Financial Stability Facility, "EFSF" and the European Stability Mechanism, "ESM") to date have had a marginal impact (ESM is a brand new mechanism.) As the rule is that support under these facilities must be requested and is subject to strict conditions, governments would accept them only as last resort. Accepting such a facility would imply ceding a degree of sovereignty, which is both politically and administratively distasteful for any government. The common financial and banking supervisory agreement is a good step forward, but remains, for the time being, limited to big "systemic" banks, leaving most financial players (the ones with less than EURO 30bn of total assets) under the supervision of national central banks.

The continuing jitters have had at least one positive impact. The EU has achieved some significant reforms which would have been unthinkable at such a pace without the crisis. The need for more responsible fiscal posture and a focus on improving competitiveness has become the new policy consensus across European governments – although segments of the public, unhappy with increased taxation and reduced social spending do not share in the consensus.

While there are different interests, objectives and political environments across Europe, the crisis may lead to even deeper economic reforms, much more in the direction of competitiveness and in the favor of business and industry. The price for this is a reduction in the size of the European social welfare state, a step that no government in Europe could have even attempted in pre-crisis times.

4. What are the real obstacles to a conclusive solution

Tthe durability of this reform consensus is in jeopardy without fundamental overhaul of financial and fiscal governance in Europe, i.e. completing the institutional architecture that any sound common currency requires for stability. Without true centralized constraints on national spending, and a trans-European treasury and budget controller, there will never be sufficient confidence that Europe will either manage its escape from this crisis, or manage to prevent and address further shocks. Unfortunately, there is an array of obstacles standing in the way of fundamental reform:

First, there is no significant, common long term political viewpoint or strategy to deal with crisis; instead, political leaders are simply being carried along, reluctantly taking decisions that are 'forced' on them by the market, i.e. bond holders, and not because of any affirmative belief that austerity and 'rushed competitiveness' will actually make debtor economies more competitive. Without a consensus on what kind of reform is necessary, there is little hope of launching a productive debate.

Second, the goal of a fiscal and financial union is stymied by the very reforms themselves, which involve transferring even more national authority to Brussels, something that few if any European electorates will support. Due to the crisis and its consequences (including tough social state reforms), large majorities of Europeans have lost confidence in the capacity of EU institutions, and governments acting together, to address the crisis. The belief that ceding more power to Brussels and related EU institutions would create more prosperity and development is waning.

Third, taking such breathtaking steps will require political vision and courage, elements that are consistently absent in Europe. Only the imperative of crisis could supply the necessary courage to take such steps. However, as the immediate crisis subsides to a degree with each successive bailout (although leaving the underlying problem intact), so does the intense, verge-of-a-catastrophe pressure necessary to goad European leaders into taking the political risk that fundamental reform entails.

Fourth, national interests still prevail over common European ones. Since the Euro crisis exploded, EU national governments, which are still the key decision makers, have privileged their national interest, failing to demonstrate a credible will to a long term vision of Europe. Germany and the Nordic countries do not want a political union that means formalized sharing of debt. This is because they still suspect that indebted countries (in the South, plus Ireland) have not made structural and other reforms, so that even if there were a mechanism for 'political union', they would effectively be underwriting the bonds of countries which will continue irresponsible borrowing practices, amidst bloated government budgets and regulation-heavy, union-favorable private sectors.

Even if Germany, Finland, Austria, the Netherlands and few others overcame both their own skepticism and the reticence of their publics necessary to support political union, it is difficult at the moment to devise a supra-national European Treasury and budget controller in whose the power of EU states could acquiesce. An EU 'Treasury' with the powers effectively to control budgets and fiscal policy/practice across the EU space (or even within the Eurozone) would threaten the national sovereignty of the constituent states (which the

publics/voters would unlikely support in referenda), and would also threaten the power of political leaders (which Presidents and Prime Ministers do not relish.).

Fifth, competition for European leadership between France and Germany still dogs Europe, and complicates the quest to put European interest above the national interest. Germany is unwillingly to take any (costly) long term commitment to defending the Euro without leverage on the “final word” in political decisions. This is what lies behind the “controls” debate and the eventual creation of an EU controller with powers on national budgets. In fact, this controller’s powers would likely mirror the lines of the ECB treaty, giving a prevalent role to economic sustainability issues and de facto reducing further any room for national states independent policies. In the end, it would be a major step towards political union, but more aligned to the German view of how that union should proceed. At the moment, it is unclear what the main players (led by Germany and France) really want. Nobody seems to have a clear vision (or to be willing to communicate it) of the long term future for Europe.

So, what we are left with is a troika-driven policy (EU, ECB, IMF) which is constrained, in the end, by a few member states (Germany first, but not alone) which are the major source of financing for bailing out indebted countries. And Germany is adamant that the indebted make fundamental structural reforms, as the price for their financing. In the meantime, as social pressures occasionally mount in Greece, Spain, et al, there is push back, or simply foot dragging (in Greece especially) as some cuts are made, but no real structural reforms are achieved. In short, it is wrong to believe that Europe is ‘dealing effectively with the crisis’ Instead, Europe and the troika are playing a dual game, continuing to push hard for reform, while doling out bail outs at the last minute in order to keep the markets/creditors at bay.

5. Beyond Greece: The Spanish and Italian cases, and the ‘war of currencies’

Looking forward, it will probably not be Greece that will likely trigger a Euro-wide collapse, because the amounts needed to cope with a Greek crisis are sustainable. In short, Greece is small enough that it can be saved from the outside. Spain is a much more serious potential ‘domino’ that could cause a chain reaction. Although its debt-to-GDP ratio is relatively sustainable at 70% (compared to 170% in smaller Greece), the Spanish economy is much larger than Greece’s and the crisis in Spain, a construction bubble that has devastated the real estate and construction sectors, appears intractable. With one Spaniard in four unemployed, Madrid’s capability to use the tax levy to cope with public needs is drastically reduced.

The ultimate Euro crisis would be triggered if contagion arrives to Italy, an economy that is literally ‘too big to fail.’ It is commonly understood that if Spain were to sink, then eventually sufficient resources for a bail out or at least massive support could be mustered. But the same is not for Italy, which is close to two times larger in terms of GDP. And contagion is plausible given how inter-linked the Italian and Spanish economies are and that the market would clearly understand that no rescue plan is possible should a real crisis explode. Nevertheless, Italy is in better shape than Spain: its economic backbone is more diversified; its unemployment rate a more manageable problem (at 10 to 11%), and finally, business, banking and labor in Italy grasp that after Spain, there is no safety need big enough to save the Italian economy, yielding much-needed sense of realism in Rome, Milan and Torino.

In the end, if one wants to prevent the unthinkable in Italy, the task is to prepare for the possible in Spain. Preparation should be undertaken well before Spain might arrive at the point of bailout, as the markets will perceive that whatever effort made to support Spain would dry up all resources for potential crisis in Italy (whose public debt is over EURO 2 trillion, i.e. too big to bail out).

Complicating these preparations, indeed aggravating the risks of contagion, is an incipient 'war of currencies' due to lack of coordination among leading central banks. The US Federal Reserve is determined to keep interest rates low at least until 2015. However, the ECB lacks the Fed's tools, such as 'quantitative easing' (purchase of Treasury bonds) to effect low interest rates (and thereby lower exchange rates.) This leaves the Euro relatively overpriced, further weighing down exports not just from strong economies like Germany's, but weaker ones as well.

Bereft of the array of monetary policy tools available to the Fed, the ECB's Governing Board launched a new financing mechanism on 2 August 2012: the "Outright Monetary Transactions" (OMT) program[2]. This permits the ECB, under certain conditions, to purchase the secondary market sovereign bondS issued by certain Eurozone member-states. Such program is activated only upon the request of the bond-issuing Eurozone government, and provided the government agrees to ensure domestic economic measures meant to facilitate a stabilization. As with the Fed's quantitative easing, the aim is to lower borrowing costs. In this way, the OMT would boost confidence in the Euro, encouraging the private market to buy up remaining bond issues in the market.

The OMT has already had an 'announcement effect' lowering significantly sovereign spreads of Italy and Spain over Germany. Nevertheless, the actual employment of the OMT is subject to question. The ECB's Governing Council was split over the decision to adopt the OMT and high level German officials, ever anxious about underwriting the debt issues of irresponsible Eurozone governments, expressed publicly their opposition. Some economists have voiced their doubts about OMT's effectiveness in addressing the European debt crisis, arguing that the program will fail because it doesn't address the core problem[3] or the sharp recession in Southern Europe and the need to have a budget expansion – all rejected by Northern countires.

In the end, the Euro crisis remains a structural problem and needs a comprehensive response, including resolving questions over the ECB's ability to manage independently monetary policy.

6. Towards a Trans-Atlantic Solution

The solution to the sovereign debt crisis and the restoration of confidence in the European project are critical for recovery in the US and the stability of worldwide financial markets. For the moment, even as the UK prepares to hold a referendum on its continued

[2] See "Technical features of Outright Monetary Transactions", ECB Press Release, 6 September 2012. In fact OMTs are not the same as Quantitative Easing operations. These latter have a monetary policy impact, as the central banks may buy bonds and, by doing so, inject liquidity into the banking system, so expanding the monetary base. The ECB has made clear that the principle of full sterilisation will apply, and it will absorb back the money injected into the system.

[3] See the article by Bill Mitchell on September 11th, 2012:"The ECB plan will fail because it fails to address the problem" (http://bilbo.economicoutlook.net/blog/?p=20935).

membership in the EU, most European leaders have ruled out the possibility of a 'contraction', or reduction in the size of the Union. The hope is that a Greek exit from the Eurozone will be forestalled, and that Italy and Spain will avert financial panic.

Even if that hopeful scenario materializes, the structural differences between Eurozone economies will remain. Only fundamental institutional reform can address that. However, Europe has proven itself, repeatedly, incapable of achieving that.

The implications for the US economy of Europe's persistent inability to address its problems except by 'buying time' are enormous. An exogenous shock or miscalculation or inability to come to terms at another critical moment, and contagion could set in and spread across the Atlantic, shuttering hopes for pick up in the US recovery. Given the limited ability of EU institutions or European leaders to come to grips with the fundamentals, US leadership remains crucial. Perhaps the only way to restore a credible vision for the future of Europe is through the Trans-Atlantic partnership, including:

1. A renewed US commitment to a reinforced economic cooperation area.

2. A US-EU Comprehensive Free Trade Agreement. A trade deal would be the most immediate way of injecting confidence.

3. For the medium term, an embryonic, tightened Trans-Atlantic (the US, Canada and the EU) economic area.

4. Given the implications that an EU-US trade agreement would have on the long term exchange ratio between the US dollar and the Euro, a wholesale review of the Bretton Woods structure would be timely.