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The Euro Zone's Double Failure

The recent euro-zone summit was a double failure. It failed to achieve the increased European political integration that was the primary goal of German Chancellor Angela Merkel and the other European political leaders. And it failed to improve the outlook for euro-zone sovereign bonds because those politicians continued to insist that only a fiscal union and political integration could limit the interest rates on sovereign debt.

The post-summit communiqué proclaimed that each euro-zone country will enact a constitutional rule to balance its budget, will take corrective action if its "structural" deficit exceeds 0.5% of its gross domestic product, and will face penalties if its actual deficit exceeds 3% of its GDP. Chancellor Merkel had hoped that these rules would be embodied in a revised version of the current EU treaty and therefore enforceable by the European Commission through the European Court of Justice. Yet Britain's unwillingness to modify the existing treaty without additional safeguards for the British economy means that the new rules would apply only to the 17 euro-zone countries and others that wish to join them, but that they don't constitute an official EU treaty and therefore cannot be enforced by the commission and other EU institutions.

So there really is no enforcement mechanism for the new budget rules, even if all of the euro-zone governments agree to sign a new accord. The result looks like a replay of the old Stability and Growth Pact that had similar goals and penalties but was soon violated by Germany and France and then watered down to be completely ineffective.

Although Chancellor Merkel, French President Nicolas Sarkozy and EU President Herman van Rompuy tried to use the current crisis to advance their political goal of European integration, their failure to achieve that goal need not prevent a lowering of the interest rates on the sovereign bonds of Italy, Spain and others. Those interest rates can be reduced by individual country policies to bring down current and future budget deficits.

Italy has a good shot at persuading investors that it has a favorable long-term budget outlook. Its fiscal deficit is now less than 4% of GDP. Even before the budget tightening by the new government of Mario Monti, the International Monetary Fund projected that Italy would have a balanced budget in 2013. Although the recent fiscal tightening may depress Italy's 2013 GDP and temporarily raise the deficit, the proposed change in national pension rules will shrink future deficits and put the ratio of debt to GDP on a downward path. If the new government can now enact changes in labor rules and investment incentives that raise GDP growth to a 2% annual rate, Italy's ratio of debt to GDP could fall to 60% in less than 15 years.

It's wrong to speak about Greece and Italy in the same breath, as the euro-zone politicians did when they insisted that Greece had to be rescued to prevent a default in Italy. That undermines confidence in Italy. Greece has a budget deficit of 9% of GDP, a current account deficit of 8%, and a GDP that is collapsing at an annual rate of more than 5%. Greece cannot hope to get its deficit under control fast enough to stabilize its debt and attract private lenders. Instead of remaining a permanent ward of Germany and the IMF, Greece should default on its debt, leave the euro zone, and return to a more competitive drachma.

Mario Draghi, the new head of the European Central Bank, has clearly and correctly rejected the French

suggestion that the ECB should announce that it will buy whatever quantities of Italian and Spanish bonds would be required to keep their interest rates at low levels. Doing so would violate the ECB rules established in the Maastricht Treaty that prohibit ECB bailouts of insolvent member governments. It would also destroy the incentive for politicians in Italy and Spain to make the politically difficult changes that will lead to lower future deficits. And it would weaken international confidence in the ECB and therefore in the euro.

Although the ECB may occasionally buy sovereign bonds to prevent spikes in interest rates, the proper priority for the bank is to deal with the private credit crisis that now threatens the European economies. Interbank lending is drying up because banks are uncertain about the liquidity and solvency of potential counterparties. This effect of the banks' exposure to euro-zone debts is frighteningly reminiscent of the dysfunctional credit markets in 2008 caused by U.S. and other banks' exposure to subprime debt and mortgage-backed securities. The problem is exacerbated by the increased capital standards that are causing European banks to reduce lending.

Mr. Draghi should indicate that the ECB will make private credit more available by lending to banks against good private collateral. But he should also make it clear that lending against private collateral should not be used by commercial banks to free up funds to purchase newly issued government bonds. In the same spirit, he should also reject the proposal to have the IMF use deposits from the ECB to buy bonds of Italy and Spain.

But what should be done if global private investors are unwilling to buy the 300 billion euros of Italian bonds that are scheduled to be sold during the next 12 months? Fortunately, only about 40 billion euros are needed to finance the projected budget deficit, while the rest is needed to roll over existing bonds as they come due.

One option would be to go to the IMF, which is already monitoring Italy's fiscal performance. The fund should be willing to provide the necessary credit without demanding tougher fiscal conditions. Yet if it is not, Italy could cut spending and raise taxes to eliminate the deficit and then repay the maturing debt with new bonds rather than cash. As Italy shows its determination and its ability to reduce future deficits, it should be welcomed back to the capital markets.

The Merkel-Sarkozy team should recognize that they have been on the wrong track. Europe needs country-by-country fiscal reforms and not a renewed push for a fiscal union and political integration.

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