A SYMPOSIUM OF VIEWS

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Eurozone Austerity:

Will the Medicine Kill the Patient?

Will the various EU summits' fiscal austerity measures alone be enough to resolve the sovereign debt crisis, or will the proposed reforms simply stymie economic growth? Is the eurozone entering a vicious cycle in which efforts at fiscal reform to demonstrate fiscal rectitude to financial markets actually lead to a weaker economy and lower tax receipts, thus exacerbating the debt situation? Does austerity by itself represent a medicine that could kill the patient?

More than twenty important global strategists weigh in.

There is an old saying, "Beware of Greeks when they come bearing gifts." The saying now needs to be reversed and applied to Germany.

SAMUEL BRITTAN
***Columnist,* Financial Times**

Near the beginning of Paul Samuelson's introductory economics text, there is a warning about the "fallacy of composition"—the belief that what is true for the individual holds good for a collectivity such as a nation or group of nations. Although that book sold in the millions, for all the notice that is now taken of the warning it might never have been written.

The national budget is not like a personal or family budget and needs to go into deficit when monetary policy on its own is unable to prevent a severe recession. The opposite belief in so-called "sound finance" is a drag on growth in many European countries. The pacemaker for this mistaken belief is Germany. But few if any leaders of other countries have had the courage to oppose it openly.

Conventional cuts in national budgets are, by their adverse effects on growth, undermining the budget balancing strategy. Germany has escaped these effects because an export surplus has maintained demand. But not every country can have an export surplus. The single currency—the euro—while it lasts stops other countries from allowing movements of the exchange rate to help achieve external balance and leaves the whole burden to be borne by restrictionist domestic policies.

No doubt if austerity went beyond "cuts" and involved tearing up state social security pledges and abandoning health and education programs, budgets could be balanced at very low levels of activity and employment. But I sincerely hope the so-called "social unrest" would prevent that from happening.

There is much to be said for privatization in countries like Italy as a structural measure, but not as a cosmetic means for reducing public debt. Eurobonds are simply a roundabout way for Germany to finance the budget deficits of peripheral euro members. The German public is understandably opposed. So should be the supposed beneficiaries. There is an old saying, "Beware of the Greeks when they come bearing gifts." The saying now needs to be reversed and applied to Germany. There is no substitute for the peripheral countries regaining control of their own exchange rates, that is, leaving the ill-begotten euro.

Fiscal consolidation and growth are not inconsistent goals. Look to Germany, Ireland, and Estonia as examples.

YVES MERSCH
President, Luxembourg Central Bank

Since spring 2010, the sovereign debt crisis has been weighing heavily on the euro area. Several of the single currency's member states face a combination of elevated debt levels, high budget deficits, and anemic growth. Although the public finances of the currency area as a bloc are in a much better position than those in other currency areas of similar size, market distrust and the risk of contagion has called for decisive action and disclosed the need to fix the mistakes of the past.

As the sustainability of public finance in several countries is being questioned, confidence needs to be restored. Suspicious markets have a huge appetite for quick fixes. In this respect, Eurobonds seem to be beneficial for financial stability in the short term as they would pool liquidity immediately. But the transfer of risk to stronger euro area sovereigns might undermine incentives for governments to lower their national levels of public debt. Sound fiscal policies, however, are indispensable in an economic and monetary union.

Therefore, the issuance of common debt instruments is only feasible after a comprehensive governance reform process that includes a significant transfer of fiscal sovereignty to the Union level.

In the meantime, the public debt burden still has to be reduced. But some argue that fiscal consolidation kills growth and by doing so it would lead to a vicious circle of weakening economic activity and ever lower tax receipts.

Arguably, in the current environment it is essential to buttress sustainable growth and this is by no means an easy task.

However, the combination of fiscal consolidation and growth is possible. Even within a monetary union—that is, without recourse to nominal devaluation of a country's own currency—individual countries can regain competitiveness. Historical experience from the euro area has proved this already:

- Germany had a serious competitiveness problem after its post-unification boom, but introduced structural reforms and sound fiscal policies, focusing on unit labor costs.
- More recently, in Ireland public wages were cut, and benefits and services were reduced. At the same time, unit labor costs have fallen by 8 percent nationwide. The economy expanded by 1.6 percent in the second quarter of 2011.
- Estonia, which introduced the euro in 2011, imposed even more severe austerity measures—and still managed to regain competitiveness. After a deep recession in 2009, growth and employment have soared since then.

Higher competitiveness will increase the flexibility of the economy and lift the longer-term growth potential. Structural reforms can strengthen confidence, market dynamics, and job creation. In particular, rigidities in labor markets should be removed to increase wage flexibility.

Improved supply side conditions should also help to dampen the negative short-term impacts on aggregate demand that kick in while fiscal consolidation measures are implemented. Moreover, they can generate a wealth effect that motivates consumption and reduces excessive incentives to save.

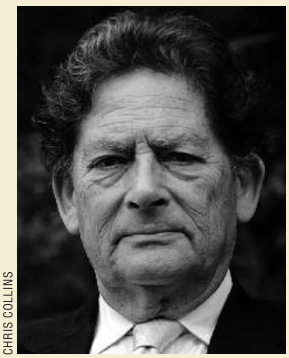
Fiscal consolidation is unavoidable and necessary, and national governments need to correct excessive deficits and move to balanced structural budgets in the coming years. However, fiscal consolidation is not a sufficient condition to resolve the crisis. It needs to be paired with ambitious structural reforms to bolster confidence, lift potential growth, and strengthen job creation.

The austerity cycle, while painful and socially destabilizing, could be short.

BARTON M. BIGGS
Managing Partner, Traxis Partners

I was an English major, not an economist, and am light on the technicalities, but my more philosophical perspective is that for better or worse, we are where we are in Europe's crisis. Frau Merkel may not like it, but the markets—not the politicians—rule and have the last word. Summits, words, veiled hints of policy changes are "sound and fury signifying nothing." It's unfortunate that the authorities seem unaware of Walter Bagehot's long-ago but still brilliant dictum that in the face of a crisis, policymakers must always err on the side of doing too much because the cost of doing too little is always so much higher eventually.

A year ago or even a few months ago the dilemma for me was Keynes versus Hegel and I would have voted for Keynes. Now it's too late; too much water has flowed under the bridge, the disease of sloth is too entrenched, and so Europe will have to endure a severe regime of Austrian austerity and creative destruction. Today Keynes, a man who famously said, "When the facts change, I change my mind. What would you do, sir?" might well agree with a dose of austerity. He would have been appalled by economies running huge deficits and debts instead of creating surpluses and paying down debt when growth was strong. Today we are where we are, and I'm afraid it's too late for Keynesian medications. Austerity will be very painful and social stability will be at risk. However, the vicious cycle suggested in the original question could be steep but relatively short and eventually transformed into a virtuous circle if confidence is restored and progressive reforms such as privatizations are implemented.



CHRIS COLLINS

The only rational course: An orderly dissolution of the eurozone.

NIGEL LAWSON
U.K. Chancellor of the Exchequer, 1983–89

There are three separate but interconnected issues here. The first is the future of the eurozone. I was only one of several who, right from the start, pointed out publicly that it could not work without a full fiscal union and therefore a full political union, the United States of Europe, which the peoples of Europe did not want; and that therefore it was doomed to disaster, both economically and politically. Of course the principal promoters of this irresponsible venture well understood the connection. It was always an entirely political enterprise designed to bring about full European political union. Arrogantly, they believed that their determination should—and could—

override the democratic veto. Clearly, the only rational course is an orderly dissolution of the eurozone, the sooner the better.

The second issue is the present danger arising from this misconceived venture: a European banking meltdown caused largely by the toxic eurozone sovereign debt the banks hold. There will inevitably be sovereign defaults, politely described as rescheduling (or even "reprofiling"); which makes the case for buying time along the lines that the Latin American sovereign debt crisis was successfully managed during the mid-1980s. Where individual eurozone countries do believe they need to step in to avert a major bank failure, this should be done by the injection of fresh equity capital on a scale that would make the existing bank shares virtually worthless, and it goes without saying that the entire top management of the banks concerned should be sacked. Capitalism and the market economy work satisfactorily only if the rewards of success are fully matched by the penalties of failure. This is particularly important in banking.

The third issue is that of the least bad response of the heavily-indebted countries of the eurozone—and indeed of those outside the eurozone, such as the United States and the United Kingdom—to the continuing global recession. Forget the idea of a neo-Keynesian fiscal boost. To have any significant effect this would have to be on a scale so large that it would create far worse problems in the short, medium, and long term alike than it could conceivably solve. The right answer is a mix of much-needed fiscal consolidation, further quantitative easing, and supply-side (largely, and banking aside, deregulatory) reform. This will not of course restore normal growth instantly—but then nothing can do that.

The austerity is appropriate if monetary policy is supportive of aggregate demand.

THOMAS MIROW
President, European Bank for Reconstruction and Development

To be effective, the eurozone's remedial "cocktail" must contain three ingredients. The first is a credible commitment to policies that prevent crisis-inducing fiscal and financial imbalances in the future. The second is reforms that strengthen long-run growth. And the third is policies that support demand and output in the short run and mitigate the ongoing credit crunch.

There is no contradiction between growth-oriented reforms and the remaining elements of this package. There is also less contradiction than commonly assumed between the first ingredient—which must include fiscal rules that cement a measure of orthodoxy across all eurozone countries—and the need for short-run relief. Without anchoring expectations—reassuring investors on the strength of eurozone policies in the medium and long run—short-run stimulus will not work. And conversely, commitment to fiscal rules is consistent with gradual adjustment, and not the same as indiscriminate fiscal austerity.

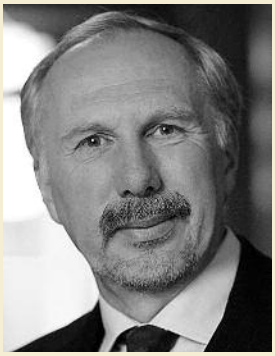
This said, many countries in the eurozone do not have the luxury of choosing leisurely adjustment paths. Even the most credible of the large eurozone economies, Germany, has little room for expansionary fiscal policy, and is currently utilizing the room that it has through tax and social safety measures that raise disposable income. This fact is often overlooked.

In this setting, support for aggregate demand must come primarily from monetary policy. Given the fact that interest rates are close to zero, this must include a willingness to take unusual measures. In this regard, the European Central Bank's recent actions have been encouraging. December's €500 billion injection in three-year funding is a very important step in this direction. European risk spreads, including sovereign spreads at the shorter end of the yield curve, have taken notice.

Europe's current policy mix—a commitment to fiscal rules and more rigorous and unified macroprudential and regulatory policies; fiscal austerity and growth-oriented reforms in the countries on the front lines of the crisis; and central bank actions to support demand and restore the normal functioning of financial markets—is fundamentally the right one.

Whether it is sufficient to turn Europe around remains to be seen. If it is not, Europe will need to become more creative in ways to support demand and contain panic without undermining the credibility of the long-term policy and reform. This might mean taking further action against the credit crunch, such as extending lending guarantees to restore the functioning of the interbank market. Another sensible idea is the German wise men "redemption pact" proposal, in which mutual sovereign guarantees would be phased in as countries make progress in reducing deficits and debt stocks.

Europe can go further. But following the extraordinary policy actions taken in December on both fiscal rules for the long run and monetary policy for the short run, there is a fighting chance that it may not need to.



A return to sustainable fiscal positions is necessary for monetary policy medicine to work.

EWALD NOWOTNY
Governor, Oesterreichische Nationalbank

A return to sustainable fiscal positions is necessary for monetary policy medicine to work. The euro area economy is slowing down and might come close to recession in 2012—not because of fiscal consolidation alone.

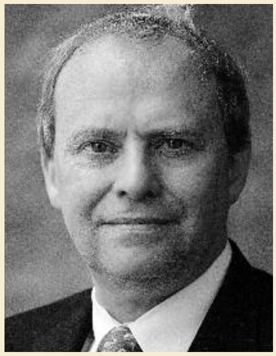
The main cause of the economic slowdown is a lack of confidence. People worry that banks may not be able to cope with losses on government debt and fear that firms and households will not be able to finance themselves—and some people have even started to doubt that monetary union is the irreversible process we thought it to be.

All these worries are inextricably linked to serious concerns about the short-term refinancing of government debt, but also to its sustainability in the long run.

Fiscal consolidation certainly risks making the looming recession worse. However, for better or worse, the economy is driven as much by expectations as it is by current events. It is highly doubtful that increased public spending will ultimately help growth when protracted high deficits at the same time undermine confidence in the solvency of governments and banks, and the future of European integration. In this context one has to be aware that Europe, and indeed the euro area, is not a homogeneous region in economic and other terms. In fact, divergences have grown during the crisis. So while reducing deficits is currently without alternative for some countries in Europe, there may be a certain room for flexibility for other countries.

More than that, re-establishing the credibility of fiscal policy is also indispensable for monetary policy to be credible and thus itself effective. Monetary policy has done a lot in the wake of the 2008 financial crisis. It can also do a lot to mitigate the negative side effects of consolidation. The clear commitment to low and stable but positive inflation rates can avert deflation and its adverse effects on government debt dynamics. Through its ability to create liquidity at will, the central bank can prevent possible difficulties in the refinancing of bank balance sheets and enable banks to fulfill their role in financing the real economy. It can also support the markets for government debt until confidence has returned.

Many observers have described the current situation in the euro area as one where we might end up in either a good or in a (very) bad equilibrium. The euro system can do a lot to support the good equilibrium. But for this to happen, the good equilibrium has to be perceived as sustainable. Liquidity support to banks and asset purchase programs will only work if they are not thought of as propping up insolvent banks and sovereigns. For monetary policy to do its job, governments have to do theirs.



This is not an austerity crisis, but a crisis of indecision, lack of focus, and insufficient financing.

ANDERS ÅSLUND
Senior Fellow, Peterson Institute for International Economics

A strange idea prevails in the American economic debate: that increased fiscal deficits are automatically stimulating, but this is obviously not true.

Japan has pursued massive fiscal deficits for two decades only to bring the country into a liquidity trap and close to default. Sweden and Finland had huge public deficits in the early 1990s, but only after they started cutting these deficits did growth return. The apprehension of a double-dip recession is much exaggerated, while the fear of sovereign default ought to be greater, because it is more likely and a true tragedy.

With an average public debt of 87 percent of GDP in the eurozone, these countries have no rational choice but to cut their deficits. The idea that even larger budget deficits and public debt would be stimulating seems nothing but odd. Remember that the International Monetary Fund urged Spain to increase its budget deficit in early 2009. How much better off Spain would have been if that unfortunate piece of advice had not been accepted.

The euro crisis is not a crisis of austerity policies because there has been minimal austerity. It is a crisis of indecision, lack of focus, and insufficient financing, which undermines confidence. Uncertainty may engender a liquidity freeze, which is the key threat. Chancellor Merkel and President Sarkozy need to focus on the key financial issues, rather than being diverted to hedge funds, tax havens, transaction taxes, and cumbersome treaty changes, make clear decisions once and for all, and provide sufficient financing.

Large, early public expenditure cuts would restore confidence and bring about substantial structural reforms that are necessary to drive new economic growth.

This will be a test for Ricardian theory.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

The notion that "structural reforms," however desirable they may be, will achieve economic growth in the near term is a chimera. Private firms will not invest if they see no prospect for selling the product of increased capital outlays. The round of austerity that Europe has now embraced is not conducive to additional private investment, unless the additional production can be sold abroad. But global demand does not look robust for the next few years at least, either in the United States or Japan, nor even in emerging markets, where growth is slowing. Only a significant depreciation of the euro could achieve larger overseas sales, and such a depreciation in current global conditions would not be appreciated, as interventions by Switzerland and Japan to prevent appreciation of their currencies suggest, and as Chinese resistance to appreciation of the yuan suggests further. It might even evoke vigorous counteractions through restrictions on trade.

Greece, perhaps not alone, has a serious problem of competitiveness, beyond its excessive public debt problem. It must undergo a period of austerity for years running into decades to eliminate its need to borrow abroad, or to induce the required capital inflow, or to generate sufficient remittances through additional Greek emigrants. The pain and duration of Greece's austerity could be mitigated by raising its value-added tax on goods, including imported goods, and using the proceeds, not to reduce the budget deficit, but to reduce taxes on private payrolls, thus making Greek labor cheaper to firms and increasing their competitiveness within the European Union and elsewhere—an approximation to currency devaluation for trade. Exports would be stimulated and imports discouraged. (Germany "devalued" by 3 percent in this fashion in 2007, enlarging an already-large trade surplus.)

Such a strategy of course would work more effectively in a buoyant economic environment. The current wave of budget austerity in Europe is not conducive to increased European economic growth in the next several years. Investment will be discouraged, and unemployed workers will be collecting government payments rather than contributing to output. The only thing to be said for it is that it will provide a test for the claim by some economists for "Ricardian equivalence," whereby reductions in expected tax payments in the distant future will encourage households to reduce their savings and spend more now, buoying consumer demand. My guess is that, sadly for the Europeans, the test will fail resoundingly.

Austerity alone won't work. The problem is lack of divergence of inflation rates.

HEINER FLASSBECK
Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

The wrong medicine will kill the patient. The main problem of the eurozone is not past fiscal profligacy in some countries. But even if it were, austerity alone would be no way out of the crisis. With confidence and income expectations of private households in most European countries at historic lows, a policy of belt-tightening by public households is definitively stymying growth and worsening the situation of public deficits and debt instead of improving it.

However, policymakers in the eurozone are not tackling the main problem. A monetary union in essence is a union of countries willing to harmonize their rates of inflation and to give up national monetary policies. The truly poisonous pill for such a union is divergence of inflation rates over many years. That is exactly what happened as Germany fought for a higher export market share by consciously undershooting the commonly agreed inflation target of 2 percent, and the southern European countries turned a blind eye to their overshooting of it.

In Germany, the domestic arm of that policy, the effort to stimulate employment creation through lower wages and restructuring of production towards more labor-intensive modes, was a complete failure. Stagnating real wages resulted in stagnating domestic demand instead of the expected exchange of lower real wages per head against more heads with unchanged demand. But on the external side the effects got stronger as small annual effects accumulated over ten years and created a huge gap in competitiveness in favor of Germany. Germany built up huge current account surpluses and southern Europe and France got the complementary current account deficits and huge external debt.

The usually applied conditionality pushing fiscal policies of deficit countries towards austerity is not only useless but extremely dangerous if the external problem is not addressed head-on. Countries having lost competitiveness and their national currencies at the same time have no choice but to restrict wage growth, which will put a further lid on domestic growth without stimulating exports immediately. The unavoidable recession or depression will question the political survival of any democratic government. Only the surplus country's willingness to encourage higher wages at home, stimulate its domestic demand, and bridge the painful adjustment of the deficit countries by eurobonds and intervention of the central bank to bring bond yields down has a theoretical chance of avoiding a breakup of the monetary union. With Germany refusing fiercely to do all this but insisting on austerity for all, a serious tool for avoiding the breakup is no longer available.

In the years 2003–06, Germany took the painful medicine and the rest of Europe threw a party. Now it's time the rest followed the German example.

HOLGER SCHMIEDING
Chief Economist, Berenberg Bank

Like all potent pills, fiscal medicine is dangerous. An overdose can kill a patient. Greece had to raise taxes and slash spending by a combined 8.2 percent of its GDP in the last two years. This savage fiscal hit in a largely closed economy weakened the Greek patient so much that Greece may not recover for years to come.

But other eurozone countries are swallowing much milder doses of the medicine. The eurozone as a whole is tightening its fiscal stance by roughly 1.3 percent of its GDP in 2012, right between the United States (fiscal hit of 0.8 percent of GDP) and the United Kingdom (1.8 percent of GDP).

The pain is distributed very unevenly within the eurozone. Germany enjoys an employment miracle and an almost-balanced budget. It needs no further cuts because it had already taken the painful medicine of austerity and labor market reforms in the years 2003–06 when the rest of Europe threw a party.

Today, it is the turn of Italy and Spain and a few smaller economies to follow the German example. By and large, the programs of the new Italian and Spanish governments make sense. Both combine the right dose of austerity (roughly 2 percent of GDP per year, measured as the changes in the underlying primary deficit) with serious pro-growth reforms.

However, the eurozone has lost the confidence of global investors. When policymakers decided in July 2011 to restructure Greek debt without protecting Italy against contagion risks, shocked global investors deserted many other European markets in droves. From demand growth modestly above its trend rate in the first half of 2011, the eurozone plunged straight into recession by late 2011. Even German growth is now stalling.

Succumbing to recession, Italy and Spain are likely to miss their fiscal targets for 2012 despite their current fiscal efforts. Europe needs to deal wisely with this. If Frankfurt and Berlin demand that Rome and Madrid react to any fiscal slippage with further hikes in taxes and cuts in spending, the Italian and Spanish economies could weaken much further.

Europe (and the International Monetary Fund) should tolerate any fiscal overshoot caused by recession. If Italy and Spain have to ask for help, such help should be granted without requests for additional austerity. Instead, Europe should use its leverage over Italy and Spain—and other potential recipients of support—to make sure that the pro-growth structural reforms to labor and other markets are fully implemented.

The German example shows that the right dose of austerity combined with long-term reforms can turn even a very sickly economy into a star performer within a few years. Of course, if need be, the European Central Bank has to be ready to support such a process by a suitably relaxed policy—and by signaling to markets that it will not allow any fiscally compliant and hence solvent eurozone sovereign to be brought down by any irrational market panic.

Fiscal austerity will not solve the crisis.

LAURA D'ANDREA TYSON
S.K. and Angela Chan Professor in Global Management, Business and Public Policy Group, Haas School of Business, University of California, Berkeley, and former Chair, President's Council of Economic Advisers

The European sovereign debt crisis was not caused by fiscal profligacy, and fiscal austerity will not solve the crisis. In 2008, Spain and Ireland were models of fiscal rectitude and investors were not worried about default risk on their government debt. Nor were they worried about Italy's chronically large government debt since Italy had the lowest deficit-to-GDP ratio in the eurozone and had no problem refinancing its borrowing needs. The real problems were unsustainable government finances in Greece and eroding competitiveness in Greece, Portugal, and Spain—problems that were obscured by the excessive convergence of bond yields following the introduction of the euro.

When government deficits increased and growth slowed as a result of the 2008–09 global recession, investors recognized that Greece was insolvent and that Portugal might be insolvent as well. Failure by the European Union to agree on credible long-term plans to restructure their debt and German insistence on unrealistic austerity measures as a condition for temporary debt relief spooked investors further and triggered a contagion effect that led to speculative attacks on the sovereign debt of Spain and Italy.

EU leaders have embraced the need for deep and immediate austerity to contain the sovereign debt problem, but too much austerity too soon will exacerbate the problem. Fiscal contraction is not expansionary—it slows growth, depresses tax receipts, and enlarges government deficits. For a country like Greece that is insolvent, austerity does not eliminate the necessity of painful debt restructuring. And prolonged austerity could drive countries such as Italy and Spain into debt restructuring that would not have been necessary otherwise.

In the long run, fiscal consolidation to reduce government deficits and debt, along with structural reforms to boost growth, will be essential in individual EU countries. But such policies will not solve the sovereign debt crisis stalking the region.

To contain this crisis, the European Union must restructure the debts of insolvent countries such as Greece and Portugal. And to counter speculative contagion to Spain, Italy, and perhaps France, the European Union must also give the European Central Bank the authority to act like a true EU-wide central bank, able to serve as lender of last resort to solvent EU member states. In addition, the European Union must provide adequate fiscal resources to recapitalize the commercial banks after completion of credible EU-wide stress tests and with transparent EU-wide conditions.

In short, the European Union must function like a real currency union—with a single currency, a central bank that is the lender of last resort to governments, and a fiscal union that can transfer fiscal resources among member states. Unfortunately, the European Union did not establish institutions to satisfy these requirements when it adopted a single currency and now it may be too late.

So-called "expansionary contraction" has not worked in practice.

MARTIN NEIL BAILY
Bernard L. Schwartz Chair in Economic Policy Development, Director of the Initiative on Business and Public Policy, and Senior Fellow in Economic Studies, Brookings Institution; and Former Chairman, Council of Economic Advisers

Supported by academic research, many policymakers in Europe argued that fiscal consolidation could actually be expansionary. Cutting government spending, in particular, would encourage private sector investment and consumption by more than enough to offset the direct reduction of government demand. Former ECB President Jean-Claude Trichet was a strong advocate of this view.

"Expansionary contraction," as it came to be called, has not worked in practice, as evidenced by Ireland, Greece, and Spain. Academic support for the view has also been undermined by a reappraisal of the evidence at the International Monetary Fund. Current forecasts suggest that the eurozone and probably the whole European Union are now entering a second recession, with even Germany showing signs of weakness. The big danger in fiscal consolidation is that it creates a downward spiral, where falling demand and employment trigger declining tax revenues and budget deficits actually get worse instead of better. Further spending cuts or tax increases only worsen the downward spiral.

This does not mean that fiscal consolidation can always be avoided, or that expansionary fiscal policy is the answer. Troubled eurozone economies are facing high interest rates as they roll over their maturing sovereign debt, and they can reach a point of no return where borrowing costs are so high that investors no longer believe the debt will be repaid and the market freezes up. Greece, of course, faced that situation and was forced to default.

The eurozone countries as a whole do have the power to contain their debt crisis, but so far the stronger countries have not been willing to guarantee the obligations of the weaker ones. No one wants to bail out the very large debts of Italy or Spain. The chances are pretty good that Germany and France, with help from the European Central Bank and the IMF, will muddle through and avoid a deeper crisis, but the participants are playing with fire. The continued uncertainty in Europe could trigger the collapse of major financial institutions that would be hard to contain. The strong economies are right to demand transparency and accountability in the fiscal accounts of countries that are asking for help, but they should look for a long-run approach to budget balance and not demand draconian budget cuts in the short run.

The United States is not helping. It is blocking the International Monetary Fund from using U.S. funds to help resolve the crisis, which is a mistake. A deeper crisis in Europe would trigger a second recession in the United States.

The problem is that unless the euro falls, the weak countries must leave the eurozone.

BERNARD CONNOLLY

CEO, Connolly Insight, LP

The problem in the euro area is the euro. It converted currency risk into credit risk. Yet the progenitors of the euro spoke as though it eliminated all risk (in 1994 then-Bank of France Governor Jean-Claude Trichet said explicitly that monetary union would eliminate risk premiums). That produced an enormous credit bubble. The first step out of denial for policymakers must thus be to admit that there will be enormous credit losses somewhere in the system.

The euro made the current account massively important. Yet euro-area central bankers argued that it no longer mattered. The weakest euro-area countries—Spain, Portugal, Greece, and Ireland (cads, as shorthand, for current account deficit)—have enormous, unsustainable (and latterly inappropriate) full-employment current account deficits. A second step out of denial must be to acknowledge that sovereign debt and banking problems are symptoms, not causes, of the euro crisis.

The credit bubble aggravated the current account problem by worsening the perverse effect of the "one-size-fits-no-one (except possibly Germany)" monetary policy in monetary union. In the early years, real interest rates were low in the four capital-poor cads, thought of as having high rates of return. This led to massive, inappropriate bringing-forward of spending from the future. When the bubble burst, risk premiums went up just when high rates of return, if they had ever existed, disappeared. Demand collapsed. Government austerity programs, however necessary, make this worse. Mass unemployment will bring deflation, increasing real interest rates at the wrong time, wrecking balance sheets, and raising risk premiums still further. The third step out of denial must be to recognize that real interest rates in the cads need to be reduced and relative prices need to adjust massively. This can be done only if the real exchange rates of the cads undershoot a long-run equilibrium level, itself very depressed. So a fourth step must be recognition that unless the euro falls to grotesquely low levels (bringing rampaging inflation in Germany), the cads must leave the euro area.

If that happens, there will be a positive role for the IMF in providing balance-of-payments loans and returning to the traditional prescription that in a country with an unsustainable external position, demand contraction alone is futile and must be combined with debt restructuring and devaluation. The recipe of austerity plus lending within the euro aggravates all problems in order to shift credit exposure from lending banks to taxpayers. Eurobonds would take this to an even more dangerous level. An explicit transfer union, in which Germany financed the full-employment trade deficits of all the cads in perpetuity, would impose a burden on Germany (one with a present value, once the full-employment current account deficits of Italy and France are taken into account, of perhaps 275 percent of German GDP) which would crush the country financially, produce a depression there, and have dangerous political effects.

Asset sales in cads would not obviously improve their balance sheets but would instead intensify the dangerous resentment of foreigners which the malignant lunacy of monetary union has done so much to resurrect.

Countries in the eurozone cannot all strive for fiscal rectitude at the same time. It is not appropriate for country, eurozone, or global growth.

CATHERINE L. MANN

Barbara '54 and Richard M. Rosenberg Professor of Global Finance, International Business School, Brandeis University, and Visiting Scholar, Federal Reserve Bank of Boston

Eurozone countries exhibit two standard imbalances: fiscal, which we hear a lot about, and external, about which we hear relatively little. All of the eurozone countries face fiscal challenges, some larger than others, but not all need immediate attention. On the external side, not all have deficits—Germany, for one, enjoys a trade surplus. How is this related to the question at hand, "What growth strategy should be added to the policy mix to resolve the eurozone sovereign debt crisis?"

The asymmetry in the forces of adjustment in the international sphere is well-known. Countries in external surplus cannot be forced to spend more, even if that would be globally stabilizing, whereas those in external deficit must retrench or face a collapse. The analog in the context of the eurozone problem today is that not all of the eurozone countries should be undertaking deep fiscal austerity measures today. Some countries have a small deficit (Germany, Belgium, Luxembourg) or have a history of rapid responsiveness of the fiscal situation (Belgium, Finland, Netherlands). Countries with room to spend more (or at minimum cut less vigorously) on infrastructure or to reduce consumption taxes should do so. But there is no mechanism whereby this can be enforced, nor is it clear that the financial markets would reward this behavior undertaken for the good of the eurozone economy, as well as the global economy.

For the countries where austerity is needed, sustainable reforms that narrow the fiscal deficit can work to increase growth through the channel of lowering the cost of borrowing. This was the outcome for the United States of the small tax increases and spending cuts during the Clinton years. Privatization is not an example of a sustainable reform, since it represents a one-off addition to revenue. For most of these countries, a sustainable reform focuses on taxes and on entitlement spending. While a long-term effort, an immediate down payment of increased tax revenue could come from combing tax records for arbitrage and avoidance schemes. Europe is the leader in investigating "harmful tax arbitrage."

In the end, the asymmetry familiarly associated with the adjustment of external balance is equally true for adjustment of fiscal balance. Countries in the eurozone cannot all strive for fiscal rectitude at the same time. It is not appropriate for country, eurozone, or global growth.

Markets and investors can sometimes be schizophrenic, so confidence is key.

JEAN-PIERRE PATAT

Special Adviser, Centre d'Etudes Prospectives et d'Informations Internationales

It is important to understand the nuances of a Keynesian vision by which fiscal "austerity" measures adopted by the euro area governments would lead to a recessionary vicious circle, for several reasons.

First, government spending is substantially higher in most of the euro countries than in other advanced economies and, despite planned fiscal consolidation, this gap will not disappear. So the "social European model" does not seem to be seriously in danger.

Second, government efficiency is what matters for growth. If public spending is relatively efficient in some northern or central countries (Germany, the Netherlands, and France), it is much less efficient in most other countries, particularly in "southern" countries where fiscal consolidation is precisely what is needed.

Third, without being an unconditional supporter of economist David Ricardo's theories, I am convinced that confidence is a crucial factor in the context of the euro area. This confidence is deeply damaged by worries about the negative consequences of massive public debt on growth and the financial situation of future generations. Clear and vigorous actions leading to a progressive reduction of this burden can restore confidence and "thaw" Europe's abundant household saving.

However, markets and investors can sometimes be schizophrenic. If I personally do not regret the absence of any reference to eurobonds which would penalize good governance and encourage bad, I regret the lack of a dynamic vision for the future in recent European Council decisions. More than ten years ago, European leaders adopted the Lisbon Agenda, with the mandate to promote the continent as the most competitive knowledge economy in the world. Concrete applications of this program never really occurred. At the same time fiscal consolidation measures were planned, euro area governments could have made clear that this ambition still held with commitments to devote 3 percent of their GDP to research and development.

There's no choice but fiscal austerity.

JULIAN CALLOW
Chief European Economist, Barclays Capital

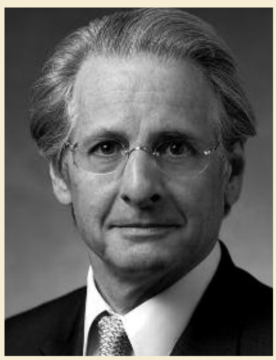
With financial markets now strongly focused on debt sustainability, Europe's high deficit/debt countries don't have a choice other than to opt for fiscal austerity. Historically, the impact on GDP from episodes of aggressive fiscal consolidation has usually been partially or even fully countered by a substantial easing of financial conditions (a much lower yield curve, and often a lower nominal exchange rate). For the "troubled periphery," such options are not available.

The good news is that by 2014, the euro area budget deficit should be down to 2.5 percent of GDP, far lower than in the United States and Japan. In addition, there is a lot of liberalization and improvements in fiscal efficiency that can be unlocked. Over time there is scope to bring down structural unemployment in many countries, and to unlock faster productivity growth. But in the context of a very aging society, and amid intense global competition, results are likely to take years to become visible, and in the interim a reform agenda can provoke supply weakness if powerful vested interests oppose it. Rapid programs of privatization and state asset sales should be strongly encouraged, since they can immediately start helping to turn debt ratios lower (particularly for Italy, the country which single-handedly has the capability to make or break European monetary union).

Therefore, the European Central Bank carries a heavy responsibility to deliver a monetary stimulus to counter the negative short-term impact of fiscal consolidation and to support governments' reform agendas. With unemployment at record highs for the eurozone, core inflation is not a problem, and interest rates should be lowered to Federal Reserve-style levels. The eurozone badly needs a much weaker euro. If it was at parity to the dollar, we would not be staring at recession in 2012: bond investors would have much greater confidence in fiscal solvency, spreads would be much narrower, and the "periphery" would see better the way out through rising exports.

That said, the European Central Bank is constrained in terms of its ability to purchase government debt by the legal framework, by cultural/historical considerations, by the lack of a single eurozone treasury, and by moral hazard issues. However, it should continue to consider imaginative ways of supporting bank lending to the private sector, such as by lending to the European Investment Bank (which should have a bigger role in promoting Europe-wide investment at this stage). It is vital as well that the European Stability Mechanism is quickly introduced and expanded in size so that it can play an effective role in guaranteeing sovereign debt.

Overall, there are no easy solutions here. The eurozone needs to plug the substantial demand shortfall generated by fiscal austerity at a time when the rules of the game (that is, the foundations of the euro area) are being comprehensively revised, in a lengthy, uncertain, and challenging process of EU "summitry." For sure the European Central Bank can engage in greater monetary stimulus, and with luck the absence of a concurrent Large Scale Asset Purchase program from the Fed will induce the euro to depreciate significantly more during 2012. However, the most vital task is for governments whose finances are questioned by investors to recover a position of demonstrably unambiguous fiscal solvency at an early stage, before the debt compounding results in a ratio to GDP that becomes unsustainable.



Of all means, regulatory reform promises the broadest avenue to growth promotion.

MILTON EZRATI
Senior Economist and Market Strategist, Lord, Abbett & Co.

Austerity alone is a poor answer for Europe. Not only do the eurozone's problems run deeper than deficits and debt, but blunt efforts to cut budgets and raise revenues threaten a vicious cycle in which fiscal restraint retards growth and so creates even larger deficits. If austerity is needed, and it is, these governments need to pursue a growth agenda as well. It is, admittedly, a counterintuitive combination, but Europe has at least four avenues along which to proceed.

In the first place, nations must focus as much on the nature of spending restraint as on the amount. Instead of across-the-board spending cuts or attacks on easy targets, such as defense, governments need to assess which spending programs inhibit growth, and target them for elimination or reduction. The candidates in this are too numerous to list here. They might include spending on generous and unconditional welfare schemes that discourage work or policies that bloat administrative bureaucracies, denying the economy presumably skilled workers who might better serve growth elsewhere. Other candidates for cuts might include subsidies to favored political classes and generally any outlays that unnecessarily divert resources, including labor resources, from activities that make the economy more efficient.

Tax reform would provide a second route. If governments must raise revenues, they might do less economic harm if the increase were coupled to a simplification of Europe's complex and often growth-stifling tax codes. A flattening of the income tax schedule to encourage work, investment, and innovation would help. Europe's governments could simultaneously increase revenues and economic efficiency by removing the tax breaks that currently go to politically favored classes.

Privatization offers yet another growth avenue. Not only would asset sales raise monies for an immediate debt repayment, but they would also foster economic efficiencies by bringing in managements that are better attuned to market signals than government-based managements typically are. To the extent that privatizations offer governments an ongoing cash flow, they further enhance growth by helping to finance essential government services without burdening the productive side of the economy with additional taxes or fees.

Of all means to growth promotion, regulatory reform promises the broadest avenue. Europe's thick regulatory regime famously makes its economies inflexible and less dynamic. European labor laws, by setting inflexible wage scales and imposing rigid rules on hiring and firing, have dissuaded managements from expanding payrolls, and so have effectively closed jobs markets to many talented workers. They have, in short, rendered European labor markets generally unresponsive to economic signals. Even the European Central Bank has singled out labor market regulation as a growth impediment. Other regulatory interferences with growth span the horizon from excessive licensing requirements to zoning laws that seem actively to discourage investment and business expansion. A review of all such rules could at last put the immense bureaucracies in Brussels and various national capitals on the side of growth.

Though the positive effects of these growth enhancements will take longer to develop than will the growth-inhibiting effects of austerity, favorable expectations, bred by such growth initiatives, could ameliorate the impact of fiscal restraint until the pro-growth initiatives can have their full impact.

Fiscal austerity is necessary. But so too is a major monetary expansion.

C. FRED BERGSTEN

Director, Peterson Institute for International Economics

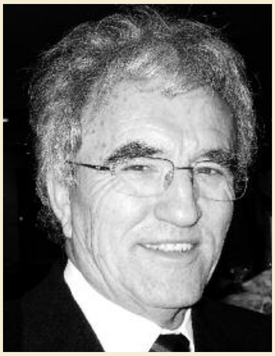
Fiscal austerity is a necessary component of a successful adjustment strategy for the heavily indebted countries of the eurozone periphery and of the zone as a whole. It is neither sufficient for those countries, however, nor is it appropriate for the stronger core countries of northern Europe and for the overall region. Successful adjustment for the zone as a whole also requires further easing of monetary policy by the European Central Bank (as well as its effective functioning as lender of last resort.)

There is no doubt that the GIIPS have been living beyond their means. Phased-in budget tightening is thus essential for them. Their delays in convincingly implementing such strategies may require them to do so, in order to regain market confidence, at a pace more rapid than would normally be economically optimal. In this sense, "expansionary contraction" can become a reality for these countries at this time.

The GIIPS must complement fiscal tightening with structural reform, however, to promote renewed growth (including via restoration of market confidence). One promising possibility is "fiscal devaluation," with cuts in indirect taxes (such as pension contributions) offset by higher direct taxes (such as value-added taxes) that can be rebated at the border. More broadly, Germany has demonstrated that rigid labor markets can be made more flexible with its Hartz reforms of the past decade. It has, in fact, shown that "internal devaluation" is quite feasible. Germany was widely viewed as facing huge economic problems only a decade or two ago, and today's "sick men of Europe" need to emulate its impressive transformation, as Italy indeed did two decades ago to qualify for eurozone membership in the first place.

Fiscal contraction is decidedly not called for at this point in Germany nor several other stronger economies in northern Europe. They should instead adopt expansionary budget measures to impart at least a modicum of growth to the eurozone as a whole, strengthening their own growth and thus the prospects for successful adjustment in the GIIPS in terms of both economics and political sustainability. Germans should buy more goods and services from the periphery and thus need to write fewer checks to it. The Bundestag should pass a law requiring all Germans to spend at least one month each year on holiday in Greece, Italy, Portugal, or Spain.

The European Central Bank should complement this strategy by cutting its policy rate by at least another 50 basis points. Along with the eurozone version of quantitative easing that it has already adopted, this is the only eurowide instrument to stimulate growth. It should be deployed to the maximum possible extent to promote successful implementation of the adjustment strategy.

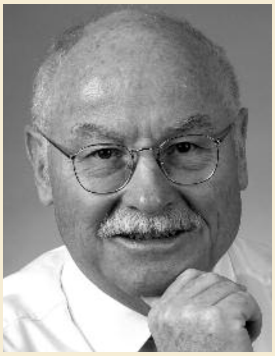


The eurozone can only be saved via fiscal union.

HORST M. TELTSCHIK
Former President, Boeing Germany, and former National Security Advisor to Chancellor Helmut Kohl

There are no easy choices. We need a triple strategy: fiscal austerity measures, structural reforms within the European Union, and a growth strategy as well. Easy to say, difficult to do. But don't forget that six governments have already fallen because of the depth crisis: Greece, Italy, Spain, Portugal, Ireland, and Slovakia. The succeeding governments have committed themselves to reducing public debts, enforcing privatization, and stimulating their economies. There is no doubt that a strategy for growth will be essential for all EU member states.

Take Greece. A task force, whose members include the European Union, the International Monetary Fund, and the European Central Bank, supervises the Greek debt crisis. The European Union has offered Greece new loans to stimulate growth and employment. About €15 billion in EU subsidies are still available for infrastructure development. An EU task force is supporting Greek administrative modernization. That's all important. But in the end, the real issue is this: The eurozone can only be saved by further fiscal integration and by creating an economic union. That's a political decision. It now appears as if the members of the eurozone are finally beginning to move in that direction.



Europe needs structured reform and further integration to succeed.

MARTIN HÜFNER
Chief Economist, Assenagon Asset Management

It's confidence that matters. Three things are necessary to bring the euro crisis to an end: reduction of public deficits in order to put state finances back on a sound footing, structural reforms to restore growth and to provide jobs, and finally further integration of the sovereign nations of the euro area to complement the European currency by a European policy of the member states. All three are vital. Up until now, progress has been made only in the first area (with the decisions of the European summit of December to strengthen the Stability and Growth Pact).

Some say that this remedy cannot work because of inherent contradictions between savings and growth. This is, however, still an open question in economic theory. Keynesians argue that consolidation of public finances depresses economic growth, because saving is reducing domestic demand. Ricardians on the other hand say that sound public finances are restoring confidence in the economy and therefore help economic growth via more investment activity. Both schools have their merits. I personally tend to believe that in the present situation of extremely high and worrisome indebtedness, the Ricardian position has the better arguments, especially when saving is explicitly accompanied by growth stimuli. If European and international investors can be convinced that their money is safe and will be repaid in time, they undoubtedly will return to the market and will buy even the paper of the peripheral countries.

Growth stimuli are no contradiction to a consolidation of public finances. What is necessary is not new money (or some kind of Marshall Plan). At stake are structural reforms of product and labor markets, privatization of state-owned companies, fighting corruption both in the public and the private sector, incentives to innovate, and other measures to improve productivity and competitiveness. In Greece the building of an industrial base is necessary. Foreign private direct investors are ready to just do that. There is no lack of capital. What the investors need, however, is the confidence that the Greeks are really paying the bills for the goods and services they get. Up until now this has not been assured. Thousands or even millions of invoices remain unpaid.

Further political integration in the euro area implies the transfer of national sovereignty to European bodies. Presently Europe has a common currency with a common monetary policy on the one hand and separate national fiscal and economic policies on the other. That does not fit together. Either the euro breaks apart and the countries return to national currencies, or the national states establish a fiscal and economic union. Some say this will never happen because the national states do not want to give up their sovereignty. I am not so sure. At the beginning of the nineteenth century, when the United States of America were as old as the European Union, there were still wars between the North and the South and a common central bank was a hundred years away. Fortunately the wars in Europe are over. The common central bank works effectively. The problems with the euro have to be seen in such a secular perspective.

A lasting solution requires tackling the underlying problems.

ANDREAS DOMBRET
Member of the Executive Board, Deutsche Bundesbank

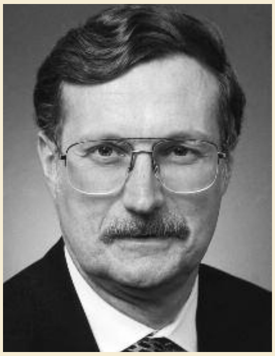
To find a lasting solution to the current sovereign debt crisis, the underlying problems need to be tackled at the root. Attempts to surmount them by resorting to quick fixes that merely mask some of the symptoms will not be sufficient. So what are these underlying problems?

First, high-risk premia on government bonds are largely due to risks to those countries' fiscal sustainability. These risks are themselves the result—to varying degrees from country to country—of fiscal profligacy, structural macroeconomic problems that ultimately led to a protracted downturn, and government support to ailing financial institutions. Second, the institutional framework of European monetary union proved too weak to prevent the crisis.

So what needs to be done? First and foremost, countries under pressure from the financial markets need to continue with forceful and credible fiscal consolidation and economic reforms. For countries with an EU/IMF support program, this requires adherence to the agreed conditionality. All European countries need to comply with the adjustments agreed in the context of European surveillance procedures. At the same time, the EMU framework needs to be solidly reinforced. First steps and decisions have already been taken to improve crisis prevention, and crucial missing elements—automatic sanctions and appropriate national fiscal rules—were announced at the European Council's December summit. Work on a permanent crisis resolution framework has also progressed. As envisaged at the summit, the consistency of the individual parts of the framework could be improved by curtailing the fiscal sovereignty of member states in cases where the rules are persistently disobeyed. At the same time, the disciplining effect of the financial markets should continue to play a prominent role. Support programs with no, or a very limited, interest surcharge largely weaken incentives for future consolidation. Finally, all this needs to be backed by improved financial sector regulation.

In normal circumstances, where confidence in fiscal sustainability is intact, fiscal consolidation is likely to have a dampening effect on demand in the short run. For countries with high deficits and debt, however, there is no viable alternative. Actually, refraining from fiscal adjustment would kill these patients. Without fiscal adjustment, risk premia and interest rates would remain high or increase further. Exacerbated by negative confidence effects, the negative impact on growth could well be worse even in the short run. Moreover, we should bear in mind that the current sluggish development in some countries partly mirrors the macroeconomic imbalances that accumulated during the preceding boom period and need correction. Structural reforms are key to improving the conditions for sustainable growth in the future.

Taking the supposedly easy option of introducing eurobonds would not only require a change to the EU treaty but also create overwhelming moral hazard problems that would erode incentives for sound fiscal policies. Without first imposing a strict enforcement mechanism for EU fiscal rules that also involved a limitation of budgetary sovereignty at the national level, the disappointing experience at the start of EMU, when some countries did not take advantage of falling interest burdens to improve their fiscal position, would probably be repeated. Regarding the ECB, assuming the role of lender of last resort for governments would ignore the existing legal framework and blur the boundaries between fiscal and monetary policy responsibilities even further, endangering the ECB's credibility and generating serious concerns about democratic legitimacy.



Fiscal austerity is not enough. The ECB must be center stage.

GEORGE HOGUET
Global Investment Strategist, State Street Global Advisors

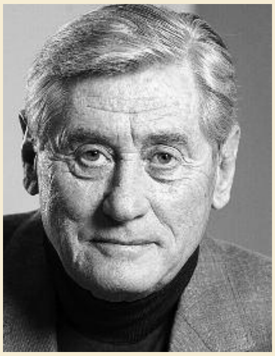
Fiscal austerity measures alone will not be enough to resolve the eurozone's sovereign debt crisis, because by themselves they are not enough to permanently raise the eurozone growth rate. Austerity measures must be carefully phased in and accompanied by additional monetary stimulus, institutional reform, and other adjustment measures in both surplus and deficit countries. The initial conditions and dynamics vary by country; Ireland's progress implies that "internal devaluation" may be effective in some cases. But Greece demonstrates the potential for a "bad equilibrium."

The situation is compounded by the short-term outlook for the eurozone economy, where output is expected to fall by as much as 1 percent this year. Risks, however, are to the downside. European banks are expected to reduce outstanding loans by roughly €1 trillion in 2012, and contagion from the periphery to the core persists. The crisis is also unfolding at a time when the eurozone's dependency ratio is accelerating, and the competitiveness of many large emerging markets is increasing.

Key policy objectives for eurozone policymakers should be to restore confidence among global investors, to erect firewalls between the periphery and the core, and to avoid a credit contraction. To stabilize market expectations, policymakers need to adopt not just financial engineering tactics but also accelerate a pro-growth agenda. The challenge is to find the appropriate balance between credible budget restraints and structural reforms in order to stimulate the supply side of the eurozone economy and make it more productive. The European Union's Lisbon Strategy for the 2000–2010 period largely disappointed, but the objectives of Europe 2020 should not be discarded. Protracted deleveraging by eurozone sovereigns, banks, and households in some countries also makes the region susceptible to additional global shocks.

Europe's policymakers and voters are best positioned to determine the optimal path. In any event, the role of the European Central Bank is likely to grow. Measures to consider in addition to fiscal austerity might include: 1) additional monetary stimulus, a more preemptive policy stance by the European Central Bank, and possible quantitative easing; 2) additional resources for the European Stability Mechanism; 3) privatizations and asset sales to sovereign wealth funds and other investors; 4) measures to stimulate consumption in Germany and to reduce imbalances within the eurozone; 5) institutional reform, including enhanced tax collection measures, a fiscal transfer mechanism, a European Treasury, a euro bond market, a European debt agency, and an enhanced European Banking Agency; 6) liberalization of labor and product markets; and 7) governance and administrative reforms. For example, in the International Finance Corporation's June 2011 Ease of Doing Business survey, Italy (where industrial production stands below 2005 levels) ranks eighty-seventh, just behind Mongolia.

In summary, while the specific dynamics vary by country, credible fiscal austerity measures are a necessary but not sufficient condition to resolve the eurozone's sovereign debt crisis. A weaker euro could also help. Eurozone leaders have intensified their engagement in recent months, and investors should not forget that over the years in other parts of the world there have been many successful cases of adjustment and debt stabilization.



The free lunch is over.

HANNES ANDROSCH
Former Finance Minister and Vice-Chancellor of Austria, and former CEO, Creditanstalt Bankverein

Any lingering notion that there might still be a "free lunch" in the sovereign debt market was forcefully dispelled in 2011. The widespread view enshrined in the Basel Accords, that OECD government debt was a riskless asset and should be priced accordingly, was finally put to rest.

For years, many European governments had exploited favorable credit conditions to indulge in electorally popular projects, or to avoid overdue structural reform of the public finances. Others were obliged to support tottering banking systems which had unwisely supported asset-market exuberance, usually in an environment of supervisory inefficiency. As a result, debt markets now perceive OECD governments, even eurozone governments, differentially and price them accordingly. Those who overindulged in the "free lunch" now find themselves in the soup kitchen.

The need to cut public-sector deficits in the presence of a large debt overhang and continuing weakness in the banking sector, as well as the unresolved issue of private-sector indebtedness in the wake of the boom, are all contributing to the weakness and slowdown forecast for the European economy in 2012. The five largest EU economies are all expected to experience growth rates between zero and 0.8 percent this year, significantly down from 2011.

Faced with such a constellation of unfavorable conditions, there is little that governments can do other than focus on getting longer-term objectives and structures into place.

The immediate problem to be surmounted is the refinancing needs of several large eurozone governments. Problems could be encountered by Italy, in particular, which faces bond redemptions in excess of €315 billion in the coming year with almost half of this amount falling due in the first four months of the year. Other countries, including Greece, Spain, France, and the United Kingdom, will have to convince investors that they are mastering the twin problems of debt and public deficits.

Moreover, governments must show that they are serious about restructuring public expenditure. Quick fixes in the form of additional taxation are no substitute for hard but necessary decisions. Important measures which must be implemented should include privatization of commercial enterprises other than genuine public services, the elimination of featherbedding in public-sector employment, a redirecting of social transfers to the truly needy, and the elimination of public support to special interest groups (for example, pension, health-care reform, reduction of subsidies), a refocusing of public expenditure on socially productive activities (such as education and research as well as social infrastructure) and, finally, a genuine restructuring of the tax system to eliminate fiscal disincentives to hiring labor.

In undertaking these measures, governments must also show greater awareness of the need to monitor the competitiveness of countries and regions of the eurozone, which have been diverging since the introduction of the single currency. In concentrating on our current woes, to the exclusion of all else, we are in danger of stepping out of one crisis straight into the next.

The collapse of the eurozone would be a setback of enormous proportions with far-reaching and disastrous implications for the global economy. It is not a reasonable option. ◆