Toward a Euro II Quarantine Zone?

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With Christine Lagarde leading the IMF and Mario Draghi as president of the ECB, there is a significant opportunity for decisive and bold action to break away from incrementalism regarding the eurozone debt crises. These leaders have made it clear that they have the firepower and will to lead the eurozone out of crises but that they need the national governments to help them take actions to assure global capital markets that the EU will not only survive but thrive.

Meanwhile, it seems like every month sheds more light on the fragility of the European fiscal situation. Attempting to address this problem country by country and one at a time will marginalize the effectiveness of the effort and continue to degrade global capital markets' confidence in the entire EU future, as is demonstrated again this month.

The principles of global risk management call for a comprehensive and common sense set of solutions that will allow the EU to settle into a gradual period of deleveraging and economic stabilization.

To succeed, we must first move from denial to risk awareness. The patients are not simply ill; they are ill with a virus. As with any virus it has spread -- Ireland, Greece, Portugal, Italy, now Spain... As with any pandemic, those who have not caught it yet are afraid of contamination; as such we have moved from pre-2008 irrational exuberance to irrational fear. Direct consequences: less troubled countries overreact and discriminate against sick countries instead of addressing the cause of the illness.

What to do? Attack the problem at two levels: first, by recognizing the interdependencies across countries (the contamination effect) and acting upon them; second, by putting the sick patients in quarantine. This will help stop the virus from spreading and allow the patients to be treated and to get them on a path to recovery.

Our first proposal relates to the formation of a centralized EU banking union. The issues are well understood and we fully support moving this idea forward: interdependent risks require more global answers. National sovereignty will likely present significant barriers, but those involved must understand that these barriers must be overcome for the good of everyone in the EU, strong and weak alike. A centralized banking union will allow global capital markets to back the ECB because they will be assured that leadership is there and willing to act.

Our second proposal is more controversial but will bring significant benefits. That is to bundle Greece, Portugal and Ireland (and maybe others) into a second currency -- call it the Euro II (E2) -- and allow those countries to begin to use a powerful tool of economic and financial stabilization, currency devaluation. Bundling these countries together into a single second currency for a period of time (hence the quarantine analogy) will mitigate the principle risk any single country exiting the euro would likely face: being attacked by global capital markets and facing severe and lengthy economic issues.
A Euro II solution, backed by a unified EU banking union, will present a capital markets opportunity and make the Euro II devaluation manageable. This will not only introduce an important additional economic management tool for the more troubled smaller economies but it will also strengthen the Euro and the ECB/IMF's effectiveness.

These coordinated actions will help convince the troubled countries that they are not being pushed outside of the European Union. Meanwhile, the IMF and the ECB would issue new (and substantial) credit enhancements to the E2 countries to allow them to issue debt while attacking their fiscal issues. Each of these E2 countries would gain from the diversification benefits, and global capital markets would have a new currency to trade and hedge. The size and economic diversification of the Euro II would provide considerable liquidity. Further, the ECB "put" would help these countries obtain credit and prevent catastrophic currency devaluations.

After their fiscal health has measurably improved, the countries in E2 would have an opportunity to convert to their own currency or (if qualified) return to a euro basis.

Decisive and coordinated moves like these may be the only way for the EU to maintain itself without centrifugal forces engulfing them and dragging them into a black hole of severe economic and social disruption.

**Will it be cheap?** No. It will be expensive but much less so than the series of one-at-a-time crises that have hurt the entire EU economically, politically and socially.

The leadership of the EU, the ECB, and the IMF will have to overcome potential conflicts involving the distribution of power in such a redesign. The countries moving to E2 will also have to recognize that this will be much less stigmatizing than any other alternative. To ensure that their electorates allow their leaders to pull this trigger they will need to be given powerful incentives. The ECB and IMF must give the E2 enough benefits to come to the conclusion that this is the best path to economic revitalization.

The time is right for bold and innovative thinking to emerge to retool and improve the EU’s governance and management capabilities. Ms. Lagarde and Mr. Draghi are a potent leadership team and should move forcefully to strengthen the EU and to convince global capital markets that they are back in the game. Our Euro II proposal will help them do just that.

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In the context of the European crisis, this opinion piece discusses an innovative proposal to bundle the most affected countries into a new currency, Euro II. This would allow for a gradual devaluation period and the possibility for those countries to come back the Euro when their fiscal health has improved. The views and opinions expressed in this article are those of the authors and not of their institutions.

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