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Firm Resolution Needed from EU to Overcome Euro Debt Crisis and earn BRICS Support

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The Italian sovereign debt market has been severely shocked by sell-offs in recent weeks as the yield for 10-year government bonds rose to 7%, a figure considered unsustainable. As a result, the cost to Italy of refinancing the debt became untenable. If this situation lasts long enough, Italy will follow Greece, Ireland and Portugal to the doors of the EU and IMF to seek help. The Euro zone debt crisis seems to continue spreading but Italy is not like other small countries. It is the third largest in the EU and is too big to fail. Yet the cost to rescue it is also too big to pay. The Italian government's debt-to-GDP ratio is as high as 118% and the volume is more than €1.84 trillion. If Italy needs to be rescued by the EU, the European Financial Stability Facility (EFSF) may not be enough to cover the funds it needs.

Why did this crisis occur after the EU settled a so-called set of solutions for the Euro zone's debt crisis in the October 27 summit? The solution involved European banks writing off 50% of their Greek debt and the banks' capital ratio being raised to 9% to withstand potential asset losses. And the EFSF was expanded from €440 billion to €1 trillion in order to help other heavily indebted countries. The EU leaders hoped that this plan would clear the clouds hanging over the Euro debt market and enhance market confidence. However, things do not always turn out as Brussels hopes. The Italian debt market showed that the EU may have prescribed the wrong medicine. What the market wants to see is an EU resolution to save the Euro at any cost, so it should provide as much funding as necessary to rescue the weaker PIIGS (Portugal, Italy, Ireland Greece and Spain). If there is a possibility that any of the PIIGS may default, speculation forces in the market would test their bottom line. This is why the crisis has spread into the Italian government debt market.

The fundamental causes of debt crisis are structural and fiscal. Slow economic growth and overspending by governments are the root causes. Although, the causes of big budget deficits and high government debt-to-GDP ratios are quite different across Greece, Ireland, Portugal, Spain and Italy, the reasons for their fall into the deep pit of government debt are similar. Their economic growth prospects are weaker than most other EU members and the markets became less confident that their debt burdens could be downsized in the near future. So risk aversion caused large amounts of selling of PIIGS' bonds. Of course, heavy market speculation, and even manipulation, is another cause of the crisis. Speculation and market rumor could easily stimulate the herd behavior, leading to large sell-offs. I think these factors triggered the debt crisis.

How to develop and implement a rescue plan

The problem is what price the EU needs to pay to rescue countries in crisis and how should it allocate the cost among member states? EU members have so far not reached a consensus and it took too long for them to respond to market doubts, greatly undermining the EU's ability to cope with the crisis. In my view, the Germany-led EU is working on a solution that will not change the existing institutions and will not have a huge cost. By demanding more strict fiscal discipline on heavily indebted countries, the EU hopes debt-to-GDP ratio in PIIGS could

drop down as quickly as by 2013 to safety levels laid-out in the Stability and Growth Pact. However this is difficult as economic growth prospects are not encouraging enough to increase tax income. By only cutting fiscal spending, the inevitable result will stir domestic resistance and political turmoil. The EU seemed reluctant to mobilize enough funds to bail out PIIGS and its rescue plan seemed framed to promote unified fiscal policy.

China's president Hu Jintao has already correctly pointed out the EU has the ability and resources to solve the Euro debt problem but only the Europeans themselves can make the decisions. To my understanding, the key to the solution is actually in German hands. Some German politicians and scholars still believe in the solution of letting Greece and other troubled southern states withdraw from the Euro zone so that those with strong fiscal discipline can revert to a healthier Euro zone. However, Italy is too important to the Euro zone and if it collapses there will be major chaos. I hope that the contagious effects of the debt crisis will worry the core EU members enough to make real resolutions to rescue the Euro. Only when these core members reach consensus and mobilize enough financial resources can the crisis be effectively cured. One of the solutions would be to let the European Central Bank (ECB) act as lender of last resort. It may cause some other problems, such as reducing PIIGS' incentive to cut fiscal deficit and stimulating higher inflation as a result of ECB creating more money. But when the Euro system is in danger and you really want to save it, you have to trade off between survival and higher inflation. Of course, the choice is difficult and it must be made collectively, otherwise the problems will last and Euro zone breakdown may become reality.

Should BRICS provide help?

Some EU officials and media hoped China and the BRICS (Brazil, Rusia, India, China, South Africa) alliance would buy Euro zone country bonds to help it out of crisis. IMF Director General Christine Lagarde also appealed to BRICS for help. Both Russia and China have expressed willingness to provide liquidity though IMF channels but want conditions established before committing to help. Therefore, the EU's core countries need to guarantee any BRICS investment. A so-call orderly default is not a good way to insure others as there is possibility of future Euro debt devaluation if the EU sees fit. If Germany and the ECB could provide ultimate guarantee that BRICS investment would not be defaulted, BRICS would be willing to provide more help.

As a Chinese scholar, I believed it is important to help Euro zone countries in order to maintain stability in the international monetary system. As the second largest international currency, the Euro plays a kind of balancing role in the system. It also represents a multipolarity trend in international currency reserves. If the Euro collapsed, the US dollar, which has proved to be problematic and unstable for the monetary system, would regain its dominant position. So for the purpose of international monetary system reform, BRICS needs to help the Euro countries.

For China, the EU is its biggest trading partner and if the Euro collapses, the negative effect on the EU economy will not be positive for China to sustain and grow trade and economic relations. So if we can help the EU out of debt crisis, it will be good also for China's trade. China is accumulating huge foreign exchange reserves and needs to diversify its reserve investment. It cannot put all its

reserves into US treasury bonds. If Euro assets meet the investment principles of safety, profitability and liquidity, China should allocate some of its reserves to them. Government bonds, or EFSF bonds, could be other investment options and guarantees by Germany or the ECB would be ideal if we want to buy the already troubled countries' debt. I think China may also let the EU issue RMB bonds in Shanghai and allow them to be converted to any other currencies on maturity. This could not only help Euro countries get finance, but also would promote internationalization of the RMB.

To sum up, China and the EU are economically interdependent. To help Euro countries overcome their debt crisis would also benefit our own interests. We should help by investing in European assets as long as the risk is controlled and the profit is reasonable. This strategy has nothing to do with domestic macro economic adjustment measures and should be immune to narrow, irrational perspectives.

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