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Fix the Banks, Fix the Currency

By Barry Eichengreen

For the euro to grow into a happy and healthy adult, many things must happen. Most importantly, Europe needs to fix its banking system. Many European banks, starting with Germany's, are dangerously over-leveraged, undercapitalized and exposed to Greek, Irish and Portuguese debt. Rigorous stress tests followed by capital injections are the most important step that governments can take to secure the euro's place.

Since European leaders seem fixated on what to do after Greece's rescue package runs out in 2013—often, it appears, to the neglect of more immediate problems—they should also contemplate transferring responsibility for supervising their banks from the national level to the newly created European Banking Authority. The mistaken belief that a single currency is compatible with separate national bank regulators is, at the most basic level, why Europe is in the fix that it's in.

Europe's budget deficits are largely a result of the continent's festering banking crisis. Greece may be an exception, but it's one of a kind. The euro area would clearly benefit from stronger discipline on borrowers and lenders. However, it is fantastical to think that this can be achieved by imposing Germanic debt ceilings Continent-wide.

The only discipline guaranteed to prevent fiscal excesses is market discipline. Reckless borrowers and lenders must be made to pay for their actions. Governments with unsustainable debts should be forced to restructure them, damage to their sovereign creditworthiness or not. The banks that lent to them should similarly suffer consequences, as should the bondholders who provided those banks with funds.

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