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Dawn of a New Day for Europe? The Merkel-Sarkozy Promise to End the Eurozone Crisis

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Failure on the part of EU leaders to address the eurozone crisis is in large part due to the fact that Germany and France are at opposite poles—politically, economically, and culturally. There is much more that divides them than unites them. Let us not forget that when it first became clear that Greece was in no position to manage its huge debt problem, French President Nicolas Sarkozy rushed immediately to express support for a bailout package, while Germany's Angela Merkel responded that a bailout must be avoided at all costs. In addition, Germany and France have been offering very different proposals for the European Financial Stability Facility (EFSF) all along, and opinions inside the two countries about monetary policy differ sharply.

In this context, the announcement made by Merkel and Sarkozy that they have agreed to a comprehensive package of proposals to solve the eurozone debt crisis is definitely a positive development. It indicates that they have set aside their disagreements—surely no small feat, since domestic political concerns have been pulling the two in completely opposite directions—in order to provide the leadership necessary for euro stability.

In practical policy terms, this means three things: (1) solving the Greek problem, (2) recapitalizing European banks, and (3) strengthening economic and fiscal policy coordination.

Merkel and Sarkozy's rude awakening is courtesy of the European banking sector. The weakness of Europe's banking system is the eurozone's dirty little secret, and the collapse of the Franco-Belgian bank Dexia may be just the tip of the iceberg. So it seems, once again, that when banks are in trouble, political leaders find a way to act as swiftly and as quickly as possible.

Of course, no one can say whether the plan that Merkel and Sarkozy will soon unveil will have such far-reaching impact as to provide permanent euro stability. Our guess is that it will not, for at least two reasons.

First, a broad set of policies to secure permanent euro stability requires massive emergency funding at this stage, probably in the range of 2 to 3 trillion euros, and massive intervention from the European Central Bank (ECB). It is almost impossible to imagine Germany and France agreeing to such a massive level of funding. But suppose they did. Where would the funds come from? While quantitative easing has been quite successful in the United States and United Kingdom,

the ECB is not only vehemently opposed to a policy of printing money, but its president is constrained by the bank's self-imposed 2 percent inflation ceiling as well.

Second, sweeping policy change would require the involvement of the national parliaments, which is another way of saying that the process of implementing any radical measures will represent a major political challenge and take a very long time to achieve.

So, what should we expect?

The banks. The most likely scenario here is that the recapitalization of banks will involve the EFSF, although Germany and France will shoulder the burden, and national governments in turn will be asked to do what they can for their own banks. In other words, it is unlikely that there will be a European recapitalization approach to the Continent's banking crisis.

The Greek debt crisis. After nearly two years of hard denial, Europe's leaders have come to a full realization that restructuring Greece's debt, with a major haircut, is the only viable solution. This would mean a substantial revision of the July 21 agreement to underwrite a second bailout, and a 60 percent haircut—essentially, a large-scale default, and it is likely that the world's credit markets would treat it as such. However, this would probably not be enough to allow Greece to bring down its debt levels through its own efforts; not with harsh austerity measures in place, which suffocate growth and keep deficits way out of control. But the back door for Greece's exit from the eurozone may have been forced wide open.

Greater economic coordination. Moves toward greater economic and fiscal coordination to keep the euro a viable currency could be wide ranging and impressive. Europe will definitely move toward a federal form of economic governance in the future, but this could still take a long time to achieve, as there are too many political obstacles that need to be overcome.

In a couple of weeks or so, we will know whether the dawn of a new day has arrived for Europe, or whether it will be business as usual in Euroland.

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