When financial markets force too much austerity

Paul De Grauwe 6 May 2010

fter the eruption of the financial crisis, there was a general consensus that financial markets and rating agencies had singularly failed in giving the right incentives to investors and borrowers. Prior to the crisis, financial markets created a belief that asset prices would grow indefinitely and that risks were low. This systematic underestimation of risks led to excessive private debt accumulation and ultimately to a crash. After such dismal failures one would have expected that no one would take the judgment of financial markets and rating agencies seriously anymore. Yet the opposite has happened. Financial markets and rating agencies are back with a vengeance. Only this time they are doing exactly the contrary to what they did prior to the eruption of the crisis. They now judge an increasing number of government bonds to be highly risky, leading investors to sell these bonds and precipitating a debt crisis in the eurozone. But if financial markets and rating agencies were so spectacularly wrong prior to the crisis, when they underestimated risks, why would they be right now? Could it be that they are now making the opposite mistake, i.e. overestimating risks everywhere and especially in the government bond markets? Few observers have asked this question today. Most seem to be conditioned again by the idea that the markets must be right, especially when they evaluate the riskiness of government debt.

It is true of course that government deficits and debt levels in the eurozone, but also in the US and the UK, are not sustainable, and that at some point it will be necessary to take certain measures to reduce these deficits. Financial markets and rating agencies today focus on this fact. They fail to see, however, the interconnectedness of government and private debt. The main if not the only reason, why government debts have exploded is that governments correctly judged that the expansion of their own debt was necessary to save the private sector, and in particular, the financial institutions. For every euro of extra government debt stands a euro of private debt that has been taken over or made sustainable by the government.

When financial markets and the rating agencies raise the risk premium on government debt today, they force the government to reduce its debt. But this has the effect of throwing the hot potato of unsustainable debt back to the private sector, and in particular to the financial system. Thus, for every 1% of extra risk premium that financial markets add to government debt, 1% of added risk premium should be added to private debt. Financial markets don't do this because they fail to see the interconnectedness of the public and private debt. As a result, they force governments today to start reducing their debts and deficits too early, thereby endangering the

Paul De Grauwe is Professor of Economics at the Faculty of Business Economics at the University of Leuven and Senior Associate Research Fellow at CEPS. This commentary was previously published as a syndicated column.

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solvency of large parts of the private sector. In this sense, financial markets are cutting off the branch they are sitting on.

This problem is particularly acute in the eurozone. Financial markets are traumatized by the Greek tragedy and are in the process of forcing similar austerity in other eurozone markets. This process is going on through the contagion effects of the Greek crisis. One after the other, the eurozone governments are forced by the fallible judgment of the financial markets and the rating agencies to exit the budgetary strategies set in place to save the private sector. In the process, an increasing number of eurozone countries are forced to cut back spending and to raise taxes at a moment when the private sector has not yet recovered. By forcing austerity now, financial markets make recovery more difficult, thereby also making it harder to correct government deficits and debts. A self-defeating deflationary dynamics threatens to envelop the whole eurozone.

Can this process be stopped? It can. But for that the governments of the eurozone have to set aside the belief forced upon them by the financial markets that the cause of the present government debt crisis is to be found in the past budgetary profligacy of the same governments. It is not. The source of the government debt crisis is the past profligacy of large segments of the private sector, and in particular of the financial sector. Tightening up the Stability Pact will do nothing to solve this problem.

In order to stop the creeping contagion of government debt crises in the eurozone, it is also essential that governments see the problem as a collective one, affecting all of them. The long hesitation in responding to the Greek crisis has intensified the contagious effects and has already precipitated a process of budgetary austerity that threatens the private sectors in the eurozone. This process can only be stopped by agreeing quickly on mutual financial support. In order to do so, however, it will also be necessary to set aside a moral and emotional analysis of the problem. This analysis has been popular in Germany where the problem has been narrowed down to the essential question of how Greece can be punished for its past misdeeds. The latest financial support programme agreed upon last weekend seems to set aside these moral objections and hopefully will help to find the right budgetary policies in the eurozone.