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Commentary

The eurozone in bad need of a psychiatrist

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There is something surreal to the unfolding financial crisis of the eurozone, as the leaders grudgingly do what is needed to prevent disaster just minutes before it's too late, and then in the next minute revert to the same behaviour that had brought them against the wall in the first place. Rising sovereign spreads within the area are the visible result of this brilliant strategy: they signal investors' expectation that the future can only bring more of the same, a series of ever-larger sovereign debt crises, under Damocles' sword that at some stage Germany, the paymaster of last resort, will close its purse and let Armageddon start.

It is surreal, first of all, because public finances in the eurozone have suffered large deteriorations but do not appear unmanageable, under present polices, and indeed in many ways are better than those of the United States, the United Kingdom and Japan.[1]

True, Greece and Ireland are now confronted with harsh adjustment programmes that raise questions of political sustainability. Punitive interest rates on EU loans to soothe German public opinion have not helped. The Irish government's decision to make good the losses of the banking system has added by one stroke about one-third to its debt-to-GDP ratio; perhaps the incoming government will reconsider, under pressure from outraged taxpayers, thus lessening future debt burdens. But for the time being both countries seem to be soldiering on with their bitter medicine, and they have now secured sufficient finance to manage their public debt in an orderly fashion until 2013.

Portugal has suffered a large deterioration in competitiveness and current external payments, but its government deficit and debt, relative to GDP, are no greater than France's, and IMF estimates indicate that a primary surplus in the order of 2% of GDP would stabilise its debt/GDP ratio. Spain has a debt-to-GDP ratio below 70% which would stabilise with a primary surplus of 1.5% of GDP, and is already taking strong measures to close its budgetary gap. Italy has a large debt but a smaller deficit, seemingly under control.

All in all, required budgetary corrections are large but not unprecedented – and the economic recovery now seems more buoyant than anticipated. Even if debt restructuring may at some stage become necessary in one of these countries due to slippages in ongoing adjustment programmes, this may not necessarily entail large losses for creditors.[2]

If this analysis is correct, financial markets are overreacting, and the most likely culprit is unsettling signals from policy-makers. Comparison with the situation in the US, UK and Japan is illuminating.

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Thinking ahead for Europe

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Like the eurozone, those countries issue debt in their own currency – currently in much larger amounts relative to GDP – but unlike in the eurozone, there is no question that their debt rollover may encounter difficulty, or that the availability of dollars, pounds or yens for their redemption may be rationed by the central bank. Within the eurozone, disagreements between national leaders make such an event conceivable and even possible. Last week, the announcement by the ECB that it was resuming its purchases of sovereign debt was sufficient to stabilise deeply unsettled markets.

This is where the eurozone may be more in need of a psychiatrist than a financial guru. Our paramount problem is to reassure unsettled financial markets that sufficient finance will be available to manage the sovereign debts of all eurozone members: if we succeed, the money will actually not be used. But our eurozone leaders keep talking about bailouts and defaults, and ride on domestic fears that taxpayers will shoulder the debts incurred by others. After each intervention, their visible disagreement on what to do next invites the next crisis: like mountain climbers suffering from vertigo, they seem irresistibly attracted to a precipice brought ever closer by their uncertain steps.

Let's be quite clear: along this path at the end of the road either all of our sovereign debts become German public debt, or the euro will disintegrate into many separate currencies, with horrendous economic dislocations.

It is high time for our leaders to reassure investors that all sovereign debts within the eurozone will be rolled over in an orderly manner, which is quite the contrary to the weird obsession to write in the Union Treaty that they will lose their money. Moral hazard – fear that profligate governments will then be led to engage in even more profligate behaviour – can be countered by appropriately tough conditions in EU loans.

Thus, not only should the European Financial Stabilisation Facility (EFSF) be made permanent, but its resource ceiling should be increased upfront by a multiple – rather than ominously hinting that it may need an increase if another country runs into trouble. The recent EcoFin Council failed to recognise this simple truth. Perhaps wiser conclusions can be hoped for when the European Council meets next week.

Moreover, the EFSF's remit should be broadened to include purchasing sovereign bonds when their markets come under strain, if need be with liquidity support from the ECB. This is a better alternative than letting the ECB purchase the bonds, since the ECB would not become directly exposed to the member states in need of financial support and fears of monetisation would not arise.

Its remit should also include injecting capital into ailing banks of countries under its assistance – with intervention rules making clear that equity holders and creditors will fully bear their losses. A credible commitment that banks, rather than taxpayers, will pay for mistaken lending is the best way to combat moral hazard within the financial system.

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[1] Cottarelli, Forni, Gottschalk and Mauro, *Default in today's advanced economies: unnecessary, undesirable and unlikely*, IMF, September 2010.

[2] On this, see Daniel Gros, "All together now? Arguments for a big-bang solution to eurozone problems", CEPS Commentary, 6 December 2010. While I disagree with its big-bang proposal, the note contains suggestion for managing debt restructuring that would minimize financial market disruptions.