

The proper diagnosis

Profligacy is not the problem

Solving the euro-zone mess means understanding the nature of its ills. And by insisting it is just about budget deficits, too many Europeans show they don't

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MISDIAGNOSIS is not, in itself, malpractice. Everyone, be they doctors or central bankers or politicians, makes mistakes. But when the misdiagnosis involves ignoring some symptoms and persisting in treatments that aren't working, it is not so easily excused. And that is what is going on with the euro, where a stress on demanding austerity has eclipsed the need to boost confidence.



Germany, the European Central Bank (ECB) and many others diagnose today's mess as stemming primarily from profligacy on the periphery. "It is an indisputable fact", Wolfgang Schäuble, Germany's finance minister, recently wrote in the *Financial Times*, that "excessive state spending has led to unsustainable levels of debt and deficits that now threaten our economic welfare."

If profligacy is the problem, the argument goes, austerity is the solution, with public thrift serving to rebuild investor confidence. The leaders of the euro's core countries have demanded draconian budget cuts as the price of rescue loans to troubled economies. They have pressed the Italian and Spanish governments to tighten more and faster. And they plan more deficit reduction themselves. The ECB has cheered this on and pushed it further. In August it demanded a toughening of Italy's austerity budget before it would step in to buy Italian bonds.

This medicine is harsh. Output has plunged more than expected in "rescued" countries such as Greece and Portugal, with growth prospects weakening, which drives the costs of debt up further. And it is not solving the problem. Confidence in

the Italian and Spanish economies is evaporating even as their governments accelerate the cuts. The rot is spreading. Fears have risen about Belgium, even France. The crisis is clearly getting worse rather than better.

This is because the profligacy diagnosis is incomplete, and thus misleading. The symptoms of the crisis were first seen in Greece, and Greece's mess is indeed largely thanks to its spendthrift government and its citizens' refusal to pay their taxes. But Spain and Ireland had low government debt and in 2006 and 2007 were running small surpluses: their finances were flattered by the boom and wrecked by the banking and property bust. Italy has long had a big public debt, but a reasonably stable one; its budget deficit is among the euro zone's smallest. These countries have weaker public finances than countries in the core, but not simply because their governments spent more. Nor, particularly in the cases of Spain and Italy, is their weakness so great as to justify the markets' sudden reassessment of their risk.

An alternative diagnosis explains the continuing chaos by pointing out that an implicit assumption behind Europe's financial integration—that sovereign debt was risk-free—has been overturned, and no one knows what to assume instead.

The euro project was founded on a rule that there would be "no bail-outs" of governments' debt. But, as an analysis by Peter Boone and Simon Johnson of the Peterson Institute points out, its financial plumbing developed in a way that suggested the opposite. Initially the ECB treated all sovereign bonds equally. Even when it decided to take credit ratings into account, the ECB's practices discouraged banks from clear distinctions between sovereign bonds.

Iatrogenesis to revelation

The fact that banks could turn government bonds from across the euro zone into cash at the ECB encouraged governments to borrow, and banks to rely on short-term funding to an extent now proving parlous. The central bankers cheered this process on. In 2005 Jean-Claude Trichet, the ECB's president, boasted that yields on euro-area sovereign bonds were driven overwhelmingly by "euro-area-wide shocks". There was only a small effect, he said approvingly, from "local risk factors".

Over the past 18 months the possibility of national defaults has shattered the idea that all euro-area debt is equally risk-free in a particularly damaging way. Even as policymakers refused to accept that Greece was bust, the "Deauville" deal between Angela Merkel and Nicolas Sarkozy in October 2010 set up ways to deal with national defaults. But no one knew how far the landscape had changed: which euro-zone countries would be allowed to go bust? Which debt remained risk-free?

Europe's financial structure thus became suddenly and alarmingly fragile. The excessive "convergence" of bond yields over the decade reversed as investors have factored in the risk of sovereign default. Europe's banks, which need to raise some €1.7 trillion (\$2.3 trillion) of funds in the next three years, are weighed down by their huge exposure to the region's governments. The result has been a classic panic.

The ECB has responded as a lender of last resort to the banking system, expanding and extending its liquidity lines for banks. But there has been no similarly comprehensive fallback for sovereign debt. The programme through which the ECB buys sovereign bonds on the secondary markets has not been idle: total purchases of Greek, Irish, Portuguese, Spanish and Italian debt now amount to around €150

billion. But the backstop has been grudging, intermittent, unpredictable and ineffective at stemming the surge in the bond yields of big economies like Italy and Spain that has pushed them back close to their August peak.

The ECB's unwillingness to act with force has brought to the fore a fragility in the system previously overlooked: countries not only lose their monetary independence, they lose a central bank to back their sovereign bonds. This, as Paul de Grauwe of the University of Leuven has pointed out, makes the euro zone's governments uniquely vulnerable to self-fulfilling panic over default.

The dynamic is similar to the "sudden stop" of foreign capital that lies behind many emerging-market financial crises. When emerging economies issue bonds denominated in a foreign currency, an interruption to the inflow of foreign capital can push a seemingly solvent country into default. To mitigate that risk, these countries eschew short-term debt and keep debt ratios low; some build up huge war chests of foreign currency. The IMF has in recent years set up "precautionary" credit lines which victims can tap in a crisis.

The euro area's weaker sovereigns currently have none of these defences. The beefing up of the European Financial Stability Facility (EFSF), which will allow it to provide IMF-style precautionary credit lines, will help. But the EFSF has too little firepower to support Italy. One possibility is to allow it to borrow funds from the ECB. A quicker, more powerful alternative would be for the ECB to stand behind solvent sovereigns with unconditional and unlimited liquidity. If the commitment was credible and panic abated, the ECB might not have to buy many bonds and would make a profit on those that it did.

The trouble is that the ECB and Germany, among others, are aghast at such a prospect. Purchasing government bonds, they argue, is tantamount to monetising government deficits. It would do nothing to stem profligacy; indeed it would encourage it, leading either to high inflation or to a big loss to the central bank when a spendthrift government eventually defaulted. To the extent that any euro-zone governments need support, argue these hardliners, it should be a fiscal decision by finance ministers, and come with appropriate conditions attached.

This is where the two diagnoses collide. One emphasises conditions as the only way to confidence. The other emphasises a confidence achievable only with unconditional support. The second diagnosis has the advantage of explaining why the first course of treatment has failed. It has the disadvantage of making that failure the doctors' fault.

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