Europe's Default *in* Credibility

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A cautionary tale of broken promises, misled markets, and a loss economically of simple common sense.

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Once, the smart money was betting on a new economic geography where nations were united in regional alliances to share markets and monies. Now the Euro-Union's scramble to contain a self-inflicted debt crisis provides a cautionary tale of what happens to monetary union when promises are broken, markets are misled, and geopolitical dreams override economic good sense.

Sharing of tax rolls between profligate and prudent nations was never the intent of euro founders. But it became the *de facto* result when Greece became the first insolvent member of the monetary union. EU Commissioner Joaquín Almunia's pronouncement that "In the euro area, default does not exist," was backed up by an EU/IMF €750 billion fund that promised bailouts to any and all.

Bavarian business owners became unwilling co-signors on the unchecked spending and borrowing of their Athenian neighbors; the Greek people were denied a fresh start and stared ahead to a 25 percent drop in living standards and a decade of stagnation; and the euro was debased as an "independent" European Central Bank was stuffed with €76.5 billion of risky Greek, Portuguese, Spanish, and Irish government bonds. Market prices signaled that the Euro-Union had failed its first stress test.

Much has been made of Europe's current move toward fiscal union. But from its inception, a monetary union that forbade the transfer of debt from one national treasury to another had stumbled across the line. Members were

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bound to limit deficits to 3 percent of GDP and national borrowing to 60 percent of GDP. A watchdog European Commission would enforce compliance. This *ad hoc* performance guarantee homogenized credit risk just as the common currency homogenized foreign exchange risk. Now, all member debts were transformed into "virtual" Euro-Union bonds without the fine print.

Markets applauded and soon all of Europe borrowed at low German rates. Greece's five-year cost of funds fell from 8 percent above Germany in 1998 to a 0.5 percent spread in January 2001 when it joined the euro and down again to 0.2 percent from 2002 until 2008 (Figure 1). The fiscal illusion reduced the Spanish Treasury's borrowing bill by €8–€10 billion every year.

While governments gorged on cheap debt, the overseers in the counting rooms in Brussels looked the other way. Rules without punishment for transgressors soon proved worthless. Even after a windfall of three years of revenue growth, seven of the euro's twelve members (with 77 percent of the union's GDP) were over the 60 percent debt limit in 2006. Three of these (with 24 percent of combined GDP) averaged a debt-to-GDP ratio of 97 percent. By 2010, the debts of ten of the original members (97 percent of the combined economy) had climbed over the Maastricht limit; six of these (49 percent of the union's GDP) owed 83 percent to 124 percent of national income (Figure 2). Over-borrowing was not the exception, but the new rule.

Markets that had carelessly bought euro promises in times of plenty woke up in October 2009. Greece had confessed to a true 2008 fiscal deficit of 7.7 percent of GDP and a projected 2009 shortfall of 12.5 percent, both double the fictive numbers published just months before. Investors

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were on the hook for €300 billion of Greek bonds, twice what the country warranted on its own credit. They had been drawn to lend at low-risk rates to high-risk borrowers.

Bond prices crashed, not just for Greece but for all stressed governments. Market calculators rejected the arithmetic of the stop-gap emergency funds rushed out by Germany and France. The €110 billion to shore up Greece would last only eighteen months. The €750 billion bailout fund turned out to be worth only €550 billion and fell far short of its promise to guarantee the credit of every euro member.

The will of spendthrift governments to reform and the long-term tolerance of industrious taxpayers to underwrite

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shiftless partners were deeply discounted. But most of all, investors assigned little value to the word of a union all too willing to excuse the shortcomings of colleagues across the conference table.

Stung with €300 billion worth of losses, markets insisted that the virtual guarantee of the Maastricht Treaty be made good. The price was set at €2 trillion of collateral and, as with all unsound counterparties, trading in euro promises was stamped "Delivery versus Payment."

Euro leaders now had a tiger by the tail. European banks had lent and invested multiples of their capital to

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De Facto Debt Restructuring

The restructuring of Europe's debt has been underway for more than a year. The negotiation venue is the 24/7 terminals of Bloomberg and Reuters. The Euro-Union longs for the never-never land of its youth where cheap money flowed freely and the price of bonds did not reflect the balance of budgets. Markets are standing firm for a credible plan that cleans up the excess borrowing of past extravagance and prevents today's deficits from becoming tomorrow's unsustainable debts.

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Greece and other shaky members. Indulged populations had grown accustomed to a living standard their productivity could not deliver. The *Schwarzfahrer* nations, who were hanging on to the back of the German trolley car without paying their fare, now viewed low free-rider interest rates as a matter of entitlement. Overexposed markets made the "no bailout" rule too costly to respect.

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Europe floats proposals on the news screens and the market counters with bond prices on the trading screens. Reconfigured offers and revalued bids will continue to stream until Europe and the markets strike a deal.

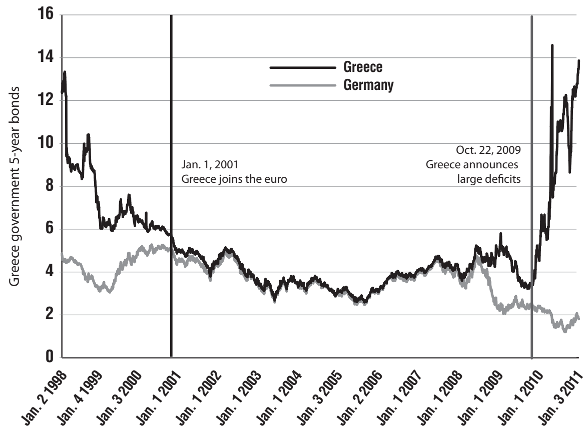
Like any sovereign debtor, Europe holds a toolkit with three resources: cash, promises, and investor losses. Cash comes from reluctant German, Dutch, French, and Austrian taxpayers. Promises are two-fold: for fiscal reform from protesting Greek, Spanish, Irish, and Portuguese citizens, and for enforcement from a slow-moving Brussels bureaucracy. Both now trade at a few cents on the euro.

Large bondholder losses are still off the table. Greece was of symbolic but not systemic importance and could have kept the euro, tightened up its budget, taken a quick 40 percent write-down of its debt, and been back in the borrowing business within months. Ireland was forced into a €67.5 billion bailout rather than force losses on the holders of its banks' bonds. Instead, more than half of their debt will move from hedge funds and banks to the tax rolls of solvent nations. The threat of default remains a reputational risk that Europe will not take.

More cash on offer reduces the interest rate on distressed member bonds, raises the rate on Bunds, and delivers an immediate impact. A heavy promises component means high rates for weak members, better rates for Germany, and a long road back to low rates for all.

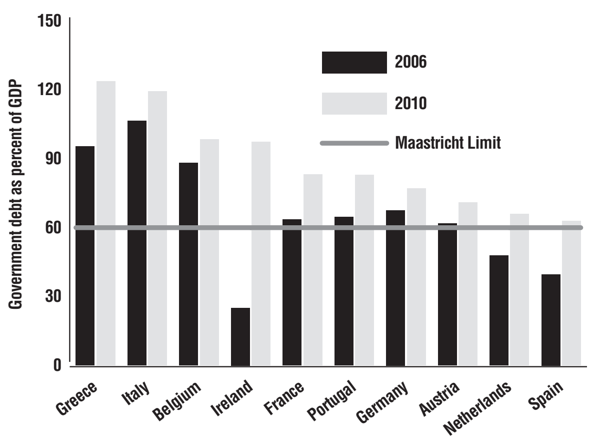
Cash has many guises, most designed to slip under the radar of public protest. Lower and lower rates on longer and longer rescue financing are a gift to subsidize distressed governments. Purchases of their bonds with union funds will inflate prices as old issues are bought up and new offerings are artificially supported. A jointly issued Euro-Union bond will level their high-risk cost of funds to the low-risk union average. A tax on financial transactions

Fig. 1 Illusion of Euro-Union Fiscal Discipline Exploded



Source: Bloomberg five-year bond yields.

Fig. 2 Excess Debt in the Euro-Union



Sources: European Commission, OECD.

to provision a war chest for bailouts will penalize the general private sector instead of the holders of their insolvent bonds. All are back-door transfers of wealth from strong to weak that raise the cost of funds for solvent members and shift risk from investors to taxpayers. Losses can be moved around but there is no magic trick to make them disappear.

Europe is trading time versus money as it gropes toward an equilibrium on the continuum between a €2 trillion backstop today to make the problem go away and zero cash plus years of austerity and unrest to regain credibility. Political and social constraints will decide the final offer, but will the union be content with the market's answer, or will investors be summoned back to "share the burden"?

While the union negotiates with the market, its members are negotiating with each other in the public eye. To bind together a collectivity of savers and spenders, of the productive and the inefficient, of the law-abiding and the law-avoiding, holds inherent conflict. A money-bags North is pushing for less cash and more stringent promises—a steel grid of automatic rules that controls how members tax and spend. An unrepentant South is lobbying for more cash and minimal promises—a warm blanket of collective credit and political agreement to cover up the failings of troubled economies and safeguard their autonomy.

The North may have the money, but the South wields what German central banker Otmar Issing calls "the blackmail of disintegration." To default and restructure remains the best economic option for the union's over-borrowed states, but it tarnishes the continent's grandiose geopolitical vision. Old Europe strives to maintain its clout in a new world order where emerging nations are crowding in to challenge its rank.

Finance ministers and central bankers in Asia and Latin America who are weighing the costs and benefits of monetary union can learn from Europe's ambiguous compromise. Will each government face bondholders on its own? If so, then discipline comes from markets that will pay for losses and set borrowing limits. Will the group underwrite every member? If so, then discipline comes from the group that pays for losses and must enforce individual debt limits. A union that cannot make up its mind is a crisis waiting to happen. ◆