Why Europe's Crisis Isn't Over

Barry Eichengreen

July 26, 2011

The dramatic announcement by European Union leaders on the evening of Thursday, July 21st that they had finally agreed to restructure Greece's debt was supposed to draw a line under Europe's crisis. In the event, it bought exactly one day of respite. By the following Monday, Spanish and Italian bond spreads had shot up again, rekindling fears that these two economies, the world's 8th and 12th largest, were about to follow Greece into the abyss.

That investors remained on edge was, in fact, predictable. They understood that the July 21st package solved exactly nothing. To start, it did not solve Greece's debt crisis. By how much it will ultimately reduce the Greek government's debt burden we don't know yet. The offer sheet published by the Institute of International Finance, the organization of big banks, is vague on the terms of the bond exchange. More than that, we don't know what fraction of the bondholders will tender their bonds and whether the participation rate in the exchange will approach the 90 per cent anticipated by the plan.

But even in the best-case scenario, the Greek government's debt will still top out at close to 150 per cent of GDP. This is too much to bear. It does not begin to return the country to solvency.

Investors understand that Greece is not out of the woods. They understand that there will be another restructuring in the future, with more haircuts for bondholders. So they are not reassured.

Why, one might ask, is the current plan so inadequate? The answer is not simply that the ECB was reluctant to agree to a restructuring, or that EU leaders worried that harsher terms might cause the International Swaps and Derivatives Association to declare a credit event that would activate credit default swaps on Greek government bonds.

The real explanation is that a larger debt write-down would have damaged the balance sheets of important European banks, French banks in particular. Indeed, the main German banks, in a stronger position, were prepared to support more debt reduction for Greece, but they could not overcome the opposition of their weaker French rivals.

From this point of view, the current strategy is like that initially adopted to manage the Latin American debt crisis in the 1980s. Serious debt restructuring was put off for seven years, until the banks had sufficient time to strengthen their balance sheets. Cosmetic measures were adopted in the meantime. But the crisis countries continued to suffer. Latin America experienced a lost decade. The fear now is that Europe may experience one too.

European leaders implicitly acknowledged this point when they proposed giving their emergency rescue fund, the European Financial Stability Facility, the capacity not just to lend to troubled governments but also to recapitalize troubled banks. If the EFSF makes intelligent use of this ability, a second, more meaningful Greek restructuring can occur sooner rather than later. Maybe the lost decade can then be shortened to a lost 3 months.

But this will be possible if and only if European parliaments, including the German Bundestag, first agree to modify the remit of the EFSF. And their agreement is no sure thing.

To increase the odds of national parliamentary assent, European leaders resisted the temptation to ask also to double or triple the size of the EFSF. A much larger EFSF would be needed if the facility is actually going to be deployed not just to recapitalize weak banks but also to provide precautionary loans to other governments on the front lines, like those of Spain and Italy, as a way of ring-fencing them against the crisis.

But with the EU having failed to turn their pop gun into a Hank-Paulson-style bazooka, investors realize that the EFSF will have only very limited capacity to support the Spanish and Italian bond markets. And the ECB, having now totally wound down its program of bond market purchases, shows little inclination to step into the breach.

More basically, the decisions taken on July 21st do nothing to resolve Spain and Italy's problems. The fundamental problem, especially for Italy, is inability to grow. Debt burdens that are just manageable when an economy is growing become unsustainable when it is not. In Italy's case, with a debt/GDP ratio above 100 per cent, the growth rate needs to exceed the interest rate on the debt.

It is revealing that the Italy's bond market reacted even more badly than Spain's on reopening for business last Monday. Spain, whatever its other problems, has at least pushed through some meaningful structural reforms, creating the possibility that economic growth will resume. Italy, in contrast, has done nothing but cut government spending, which will only weaken demand and slow its growth in the short run.

There's no silver bullet to magically solve this problem, only the hard structural reform on which Spain has embarked but Italy has barely begun. But there is a helping hand available, potentially, in the form of a more accommodating monetary policy. With Italy and Spain cutting government spending, a looser monetary policy would help to support demand – as it has in the UK, which has the advantage of a less ideologically-rigid central bank. Lower ECB rates would make it easier for the Spanish and Italian governments to service their debts. They would make it easier for Spanish and Italian firms to borrow in order to restructure. A lower euro would make it easier for them to export. The need is growing more urgent, given that the purchasing managers' indices in both Spain and Italy fell in June, raising the danger of renewed recession in both countries.

Unfortunately, the ECB appears to prefer intransigence to extending a helping hand. It may fear that Spain and Italy will see monetary help as relieving the pressure to undertake structural reforms. If so, the ECB should tell the Spanish and Italian governments exactly what it wants them to do. And if they then act, it should move quickly to lower rates and resume its bond market purchase program in order to ring-fence the two countries against the spread of the crisis.

It still is possible to draw a line under Europe's crisis. But doing so will require the cooperation not just of European governments but also the ECB.

====================================

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley. His book *Privilegio Exorbitante: A ascensao e queda do dolar e o future do Sistema Moneatario Internacionale*, will be published shortly in Brazil by Campus/Elsevier.

.