The euro area

Time for Plan B

The euro area's bail-out strategy is not working. It is time for insolvent countries to restructure their debts

FOR a few weeks over the Christmas holidays, Europeans put their sovereign-debt crisis on hold. Now they are facing grim reality once more. Bond yields are spiking in an ever broader group of countries, just as the euro zone's governments need to raise vast sums from the markets. On January 12th Portugal was forced to pay 6.7% for ten-year money—better than feared but a price it cannot afford for long. Yields for Belgian debt have jumped, as investors fret about its load of debt and lack of leadership. Spain is hanging on.

This mess leads to a depressing conclusion: Europe's bail-out strategy, designed to calm financial markets and place a firewall between the euro zone's periphery and its centre, is failing. Investors are becoming more, not less, nervous, and the crisis is spreading. Plan A, based on postponing the restructuring of Europe's struggling countries, was worth trying: it has bought some time. But it is no longer working. Restructuring now is more clearly affordable than it was last year. It is also surely cheaper for everybody than it will be in a few years' time. Hence the need for Plan B.

The initial response, forged in the rescue of Greece in May 2010, has been undone by its own contradiction. Europe's politicians have created a system for making loans to prevent illiquid governments from defaulting in the short term, while simultaneously making clear (at Germany's insistence) that in the medium term insolvent countries should have their debts restructured. Unsure about who will eventually be deemed insolvent, investors are nervous—and costs have risen.

The least-bad way to deal with this contradiction is to restructure the debt of plainly insolvent countries now. Based on this newspaper's calculations (see page 77), that group should start with Greece and probably also include Portugal and Ireland. Spain has deep problems, but even with a big bank bail-out it should be able to keep its public debt at a sustainable level (see page 79). Italy and Belgium have high debt levels but more ample private savings, and their underlying budgets are closer to surplus. There is, thus, a reasonable chance that, handled correctly, euro-zone sovereign defaults could be limited to three small, peripheral economies.

The perils of procrastination

This newspaper does not advocate the first rich-country sovereign defaults in half a century lightly. But the logic for taking action sooner rather than later is powerful. First, the only plausible long-term alternative to debt restructuring—permanent fiscal transfer from Europe's richer core (read Germany)—seems to be a political non-starter. Some of Europe's politicians favour closer fiscal union, including issuing euro bonds, but they are unlikely to accept budget transfers big enough to underwrite the peripheral economies' entire debt stock.

Second, the dangers from debt restructuring have diminished even as the costs of delay are rising. Eight months ago, when euro-zone governments and the IMF joined forces to rescue Greece, their determination to avoid immediate restructuring made sense. There were reasonable fears that default could plunge Greece into chaos, precipitate bond crises in the euro zone and spark a European banking catastrophe.

But the European economy, as a whole, is now in better shape. Banks have had time to build up more capital—and palm off some of their holdings of dodgy sovereign bonds to the European Central Bank. Greece and other peripherals have shown their mettle with austerity plans. Europe's officials have created mechanisms to stump up rescue money quickly. And lawyers have been thinking about managing an "orderly" default. A sovereign restructuring could still spook financial markets—fear that it would spread panic makes Europe's politicians shy away from it—but if handled correctly, it should not spawn Lehman-like chaos.

At the same time the costs of buying time with loans have become painfully clear. The burden on the countries that have been rescued is enormous. Despite the toughest fiscal adjustment by any rich country since 1945, Greece's debt burden will, on plausible assumptions, peak at 165% of GDP by 2014. The Irish will toil for years to service rescue loans that, at Europe's insistence, pay off the bondholders of its defunct banks. At some point it will become politically impossible to demand more austerity to pay off foreigners.

And the longer a restructuring is put off, the more painful it will eventually be, both for any remaining bondholders and for taxpayers in the euro zone's core. The rescues of Greece and Ireland have increased their overall debts while their private debts fall, so that a growing share will be owed to European governments. That means that the write-downs in any future restructuring will be bigger. By 2015, for instance, Greece could not reduce its debt to a sustainable level even if it wiped out the remaining private bondholders.

How to change course

A cost-benefit analysis, in short, argues in favour of carrying out an orderly restructuring now. The debt reduction should be big enough to put afflicted economies on a sustainable path. Greece may have to halve its debt burden. Ireland's may need to be cut by up to a third, with some of this coming from writing down bank rather than sovereign debt.

All creditors, including governments and the European Central Bank, will have to chip in. New rescue money will also be needed: to fund defaulting countries' budget deficits; to help recapitalise these countries' local banks (which will suffer losses on their holdings of government bonds); and, if necessary, to recapitalise any hard-hit banks in Europe's core economies. The ECB and others should stand ready to defend Belgium, Italy and Spain if need be.

If Europe's leaders stick to plan A, the debt crisis will continue to deepen. If they get on with restructurings that are eventually inevitable, they have a fighting chance of putting the crisis behind them. Plan B will require deft technical management and political courage. Thanks to its emerging-market expertise, the IMF has some of the former. It is up to Europe's politicians to find the latter. ■

taxes, more regulation and dirigiste industrial policy. Some of them still talk as if economic growth were a problem in itself—which is one reason they opposed the huge infrastructure project at Stuttgart's railway station. Support for free trade and free markets tends to come very far down the agenda, if it features at all.

Much of this is just the normal talk of protest and opposition. Like all parties, the Greens tend to change their tune when they get closer to power, just as they did when they went into coalition with the SPD in the federal government of 1998. In this sense, indeed, Baden-Württemberg should now offer a test of how responsible the Greens are when they actually lead a government. The state has a highly successful economy and boasts the country's lowest unemployment. It also hosts some of Germany's biggest exporters, including several large carmakers. Mr Kretschmann will surely not want to threaten any of this.

Further in the future looms another big challenge for his party, one that could have a bearing on Mrs Merkel's future. At present the Greens naturally seek to form coalitions with the SPD, as they will once again do in Baden-Württemberg, just as the FDP tends to look towards joining up with the CDU. But the success of the FDP, at least until recently, was based largely on its readiness to go into government with either of the two big parties. The Greens should follow suit. A first attempt at a Black-Green coalition in the city-state of Hamburg fell apart last November. The ultimate test of how serious a party the Greens have become will be how soon they are prepared to try once again to work with the CDU, in a state or even, after 2013, at the federal level. ■

The euro zone's periphery

They're bust. Admit it.

Greece, Ireland and Portugal should restructure their debts now

IT IS a measure of European politicians' capacity for self-delusion that Angela Merkel, Germany's chancellor, called the euro-zone summit on March 24th-25th a "big step forward" in solving the region's debt crisis. Something between a fudge and a failure would be more accurate. The leaders fell short on almost every task they set themselves. They agreed on a "permanent" rescue mechanism to be introduced in 2013, but couldn't fund it properly, because Mrs Merkel refused to put up money her finance minister had pledged. The Brussels gathering did little to help Greece, Ireland and Portugal, the zone's most troubled economies. Their situation is getting worse—and Europe's leaders bear much of the blame.

Portugal's prime minister resigned on March 23rd after failing to win support for the fourth austerity package in a year. The country's credit rating was slashed to near-junk status on March 29th, while ten-year bond yields have risen above 8% as investors fear Portugal will have to turn to the European Union and the IMF for loans. The economies of both Greece and Ireland, Europe's two "rescued" countries, are shrinking faster than expected, and bond yields, at almost 13% for Greece and over 10% for Ireland, remain stubbornly high. Investors plainly don't believe the rescues will work.

They are right. These economies are on an unsustainable course, but not for lack of effort by their governments. Greece and Ireland have made heroic budget cuts. Greece is trying hard to free up its rigid economy. Portugal has lagged in scrapping stifling rules, but its fiscal tightening is bold. In all three places the outlook is darkening in large part because of mistakes made in Brussels, Frankfurt and Berlin.

At the EU's insistence, the peripherals' priority is to slash their budget deficits regardless of the consequences on growth. But as austerity drags down output, their enormous debts—expected to peak at 160% of GDP for Greece, 125% for Ireland and 100% for Portugal—look ever more unpayable, so bond yields stay high. The result is a downward spiral.

As if that were not enough, the European Central Bank in Frankfurt seems set on raising interest rates on April 7th, which will strengthen the euro and further undermine the peripherals' efforts to become more competitive (see page 69). Some politicians are still pushing daft demands, such as forcing Ireland to raise its corporate tax rate, which would block its best route to growth. Most pernicious, though, is the perverse logic of the euro zone's rescue mechanisms. Europe's leaders won't hear of debt reduction now, but insist that any country requiring help from 2013 may then need to have its debt restructured and that new official lending will take priority over bondholders. The risk that investors could face a haircut in two years' time keeps yields high today, which in turn blights the rescue plans.

Home truths from Washington

This newspaper has argued that Greece, Ireland and Portugal need their debt burdens cut sooner rather than later. That case is stronger than ever, not only because today's approach is failing but because the risks restructuring are falling. The spectre of contagion is receding. Spain, whose bond yields have fallen and whose spreads with Germany have tightened, has distanced itself from Portugal. Behind the scenes, sovereign-debt specialists are devising ways to minimise the impact of an "orderly restructuring" on banks. Most banks in the core of the euro zone can withstand a hit from the three small peripherals.

The big obstacle is not technical but political. Since many at Europe's core, particularly the ECB, remain implacably opposed to debt restructuring, the pressure has to come from elsewhere—not least from the peripheral economies themselves. Ireland's new government is talking about forcing the senior bondholders of its bust banks to take a hit. Greece should stop pretending that it can bear its current debt burden and push for restructuring. But the best hope lies with the IMF. Its economists have the most experience of debt crises. Some privately acknowledge that debt restructuring is ultimately inevitable. It is time the Fund's top brass said so publicly and, by refusing to lend more without a deal on debt, pushed Europe's pusillanimous politicians into doing the right thing. ■

How to save the euro

It requires urgent action on a huge scale. Unless Germany rises to the challenge, disaster looms

SO GRAVE, so menacing, so unstoppable has the euro crisis become that even rescue talk only fuels ever-rising panic. Investors have sniffed out that Europe's leaders seem unwilling ever to do enough. Yet unless politicians act fast to persuade the world that their desire to preserve the euro is greater than the markets' ability to bet against it, the single currency faces ruin. As credit lines gum up and outsiders plead for action, it is not just the euro that is at risk, but the future of the European Union and the health of the world economy.

It is a sobering thought that so much depends on the leadership of squabbling European politicians who still consistently underestimate what confronts them (see page 73). But the only way to stop the downward spiral now is an act of supreme collective will by euro-zone governments to erect a barrage of financial measures to stave off the crisis and put the governance of the euro on a sounder footing.

The costs will be large. Few people, least of all this newspaper, want either vast intervention in financial markets or a big shift of national sovereignty to Europe. Nor do many welcome a bigger divide between the 17 countries of the euro zone and the EU's remaining ten. It is just that the alternatives are far worse. That is the blunt truth that Germany's Angela Merkel, in particular, urgently needs to explain to her people.

The failure of austerity and pretence

A rescue must do four things fast. First, it must make clear which of Europe's governments are deemed illiquid and which are insolvent, giving unlimited backing to the solvent governments but restructuring the debt of those that can never repay it. Second, it has to shore up Europe's banks to ensure they can withstand a sovereign default. Third, it needs to shift the euro zone's macroeconomic policy from its obsession with budget-cutting towards an agenda for growth. And finally, it must start the process of designing a new system to stop such a mess ever being created again.

The fourth part will take a long time to complete: it will involve new treaties and approval by parliaments and voters. The others need to be decided on speedily (say over a weekend, when the markets are shut) with the clear aim that European governments and the European Central Bank (ECB) act together to end today's vicious circle of panic, in which the weakness of government finances, the fragility of banks and worries about low growth all feed on each other.

So far the euro zone's response has relied too much on two things: austerity and pretence. Sharply cutting budget deficits has been the priority—hence the tax rises and spending cuts. But this collectively huge fiscal contraction is self-defeating. By driving enfeebled economies into recession it only increases worries about both government debts and European banks (see page 74). And mere budget-cutting does not deal with the real cause of the mess, which is a loss of credibility.

Italy and Spain are under attack not because their finances have suddenly deteriorated, but because investors fret that they may be forced to default. For this loss of confidence, blame the pretence. Europe's leaders have repeatedly denied that Greece is insolvent (when everyone knows it is), failing to draw a line between it and the likes of Spain and Italy, which are solvent but short of liquidity. The excuse is that a Greek restructuring may cause contagion. In fact denying the inevitable has undermined pledges about solvent governments.

Instead of austerity and pretence, a credible rescue should start with growth and, where it is unavoidable, a serious restructuring of debt. Europe must make an honest judgment about which side of the line countries are on. Greece, which is unambiguously insolvent, ought to have a hard but orderly write-down. The latest, inadequate plan for a second Greek bail-out, agreed at a summit in July, should be thrown away and rewritten. But all the other euro members (and on present numbers Portugal is just about in the solvent camp) should be defended with overwhelming financial firepower. All the troubled economies, solvent or insolvent, need a renewed programme of structural reform and liberalisation. Freeing up services and professions, privatising companies, cutting bureaucracy and delaying retirement will create conditions for renewed growth—and that is the best way to reduce debts.

How to prevent contagion? A Greek default would threaten many banks, not just in Greece: this week the markets took aim at French banks that hold southern European debt. Moreover, solvent countries need a breathing-space to push through reforms. That points to agreeing to two measures at the same time: a scheme to shore up the banks, which may take months to put into practice, and a rock-solid promise to support solvent governments, which has to be immediate.

The recapitalisation of Europe's banks must be based on proper stress tests (which should this time include possible default on Greek sovereign debts). Some banks may be able to raise money in the equity markets, but the most vulnerable will need government help. Core countries like Germany and the Netherlands have enough cash to look after their own banks, but peripheral governments may need euro-zone money. Ideally that would come from the European Financial Stability Facility (EFSF), whose overhaul was the most useful thing to emerge from the July summit. But it also makes sense to set up a euro-zone bank fund, together with a euro-zone bank-resolution authority. That is part of the longer-term institution building. However, the ECB could help the banks by giving a commitment to provide unlimited liquidity for as long as it is required, rather than a rolling six months, as now.

The great firewall of Europe

None of this will work unless the Europeans create a firewall around the solvent governments. That means shoring up euro-zone sovereign debt. Spain and Italy owe €2.5 trillion. What if the markets suddenly took fright over Belgium or France? Some have argued for a system of Eurobonds in which every country's debt is backed by all. But the political oversight to ensure that high-spending countries do not fritter away other people's money would take years to sort out—and one thing

the euro zone does not have is time. The answer is to turn to the only institution that can credibly counter a collective loss of confidence on such a scale.

The ECB must declare that it stands behind all solvent countries' sovereign debts and that it is ready to use unlimited resources to ward off market panic. That is consistent with the ECB's goal to ensure price and financial stability for the euro zone as a whole. So long as governments are solvent and the bank sells the bonds back to the market after the crisis, this does not amount to monetising government debt. In today's recessionary world, the ECB could buy several trillion euros-worth of bonds without unleashing inflation.

Even so, this is a huge step. The ECB's German officials have taken to resigning in protest at the limited bond-buying undertaken so far. They fear not only that so young an institution is vulnerable to a loss of credibility, but also that the ECB, which is independent but unelected, could become embroiled in political decisions—especially by declaring a state insolvent and cutting it off. Both these longer-term risks are real, but they are far outweighed by the need to stop the rot. It would be a nonsense if the ECB's dogged defence of monetary rigour led, say, to an Italian default and a global depression.

A bad deal, or a much worse one?

Put our plan to many Europeans—creditor Germans, debtor Greeks or Eurosceptic Britons—and they may moan that this is not what they were promised when the euro was set up. Completely true, and sadly irrelevant. The issue now is not whether the euro was mis-sold or whether it was a terrible idea in the first place; it is whether it is worth saving. Would it be cheaper to break it up now? And are the longer-term political costs of redesigning Europe to save the euro too great?

The sobering truth about the single currency is that getting in is a lot easier than getting out again. Legally, the euro has no exit clause. If Greece stormed out, and damn the law, as it might yet have to do, it would suffer a run on its banks, as depositors withdrew euros before they were forcibly converted into devalued new drachma. It would have to impose capital controls. Greek companies with international bills would risk bankruptcy, as they would suddenly be without the cash to cover them; and the pressure on other wobbly countries would increase. That is why we favour restructuring Greece, but letting it stay in the euro.

If, on the other hand, a strong country like Germany walked out of the euro, probably taking other strong countries with it, the result would be just as terrible. The new hard currency would soar, hitting German exporters. Turmoil in the rump of the euro zone would batter export markets just as the north's firms became less competitive. German banks and companies, in a mirror image of what would happen in Greece, would suffer from the sudden devaluation of euro assets outside the new hard-currency zone. And the rump might still break apart, as Italy or Spain would not want anything to do with Greece. Amid the debris of broken treaties, wild currency swings and bitter recriminations, Europe's single market could collapse and the EU itself—the rock of the continent's post-war stability—could start to crumble.

Attaching hard numbers to any of this is difficult. Analysts at UBS, a bank, reckon that euro break-up could cost a peripheral country 40-50% of GDP in the first year, and a core country 20-25% (see page 75). Yes, that is a guess (as are the various estimates for the ongoing costs of break-up and those of a bail-out in future years). But the immediate bill for a break-up of the single currency would surely be in the trillions of euros. By contrast, a successful rescue would seem a bargain. Add together the money already spent on rescues, to what is needed to recapitalise European banks and any potential losses to the ECB, and the total will still only be in the hundreds of billions of euros. If the ECB's intervention is bold and credible it might not even have to buy that much debt, because investors would step in. In short, the euro zone would be reckless to flirt with collapse when an affordable rescue is possible.

German taxpayers might accept that the immediate costs of our rescue plan are smaller than break-up. But what they detest is the idea that it might let feckless Italians and Portuguese off the hook. Safe in the knowledge that the ECB stands behind their bonds, they may shy away from reform and rectitude.

Two risks flow from this. The immediate (and real) one is that furious Germans will demand that Greece is thrown out (or bullied out) of the euro to frighten the others. Such a horrific event would indeed scare Portugal and Ireland, but a threat to expel Italy or Spain is empty: they are too big and too tightly tied into the EU. Simply chucking out Greece because it was convenient would permanently undermine the security of small members of the EU. Besides, once Greece defaults and restructures, its economy stands a good chance of making a credible start on its long journey to economic health.

The longer-term risk has to do with "more Europe". Fans of political integration say that the only way to enforce discipline is to create a United States of Europe (see Charlemagne). Perhaps a fiscal union that would supervise the issuance of common Eurobonds? Or a new supervisory role for euro-zone governments, or, heaven forbid, the useless European Parliament? Somewhere behind this also looms the idea that the ins will now be able to boss around the outs. The ten countries, including Sweden, Poland and Britain, that kept their own currencies may face a choice: to join the euro or be excluded from a new "core Europe", which in effect starts setting policies. And, this being Europe, there is every chance that the politicians will try to avoid discussing a lot of this with their electorates.

The Economist concedes that our rescue plan begins with a democratic deficit that needs to be fixed if steps towards closer fiscal union are to work. But there must be ways for good governments to force bad ones to keep in line that do not require the building of a huge new federal superstate. The Dutch have suggested a commissioner in Brussels with power to veto countries' fiscal excesses, and to impose his judgments by law. Mrs Merkel has talked of giving the European Court of Justice the right to impose good behaviour. These are big steps—make no mistake—and because they involve treaty changes they would have to be sold to voters. But they are a long way short of a United States of Europe.

Mrs Merkel, it's time to explain the choices

The outs, in particular, may still be nervous about all this. So frankly is this newspaper. But the alternative may be the collapse of not just the single currency but the single market and the whole European project. The euro has reached the point where nobody is going to get what they want—something that needs to be spelled out to the Germans more than anybody. Over the past 18 months they have grudgingly supported half-rescue after half-rescue—and the bill has gone up. In the end confidence and credibility are all. For the ECB to stand behind less prudent countries may be unwelcome to Germans; but letting the euro fall to bits is much, much worse. Spell that out clearly to your voters, Mrs Merkel. ■

Europe's rescue plan

This week's summit was supposed to put an end to the euro crisis. It hasn't

YOU can understand the self-congratulation. In the early hours of October 27th, after marathon talks, the leaders of the euro zone agreed on a "comprehensive package" to dispel the crisis that has been plaguing the euro zone for almost two years. They boosted a fund designed to shore up the euro zone's troubled sovereign borrowers, drafted a plan to restore Europe's banks, radically cut Greece's burden of debt, and set out some ways to put the governance of the euro on a proper footing. After a summer overshadowed by the threat of financial collapse, they had shown the markets who was boss.

Yet in the light of day, the holes in the rescue plan are plain to see. The scheme is confused and unconvincing. Confused, because its financial engineering is too clever by half and vulnerable to unintended consequences. Unconvincing, because too many details are missing and the scheme at its core is not up to the job of safeguarding the euro.

This is the euro zone's third comprehensive package this year. It is unlikely to be its last.

Words are cheap…

The summit's most notable achievement was to forge an agreement to write down the Greek debt held by the private sector by 50%. This newspaper has long argued for such a move. Yet an essential counterpart to the Greek writedown is a credible firewall around heavily indebted yet solvent borrowers such as Italy. That is the only way of restoring confidence and protecting European banks' balance-sheets, thus ensuring that they can get on with the business of lending.

Unfortunately the euro zone's firewall is the weakest part of the deal (see page 29). Europe's main rescue fund, the European Financial Stability Facility (EFSF), does not have enough money to withstand a run on Italy and Spain. Germany and the European Central Bank (ECB) have ruled out the only source of unlimited support: the central bank itself. The euro zone's northern creditor governments have refused to put more of their own money into the pot.

Instead they have come up with two schemes to stretch the EFSF. One is to use it to insure the first losses if any new bonds are written down. In theory, this means that the rescue fund's power could be magnified several times. But in practice, such "credit enhancement" may not yield much. Bond markets may be suspicious of guarantees made by countries that would themselves be vulnerable if their over-indebted neighbours suffered turmoil.

Under the second scheme, the EFSF would create a set of special-purpose vehicles financed by other investors, including sovereign-wealth funds. Again, there are reasons to doubt whether this will work. Each vehicle seems to be dedicated to a single country, so risk is not spread. And why should China or Brazil invest a lot in them when Germany is holding back from putting in more money?

Together, these schemes are supposed to extend the value of the EFSF to €1 trillion ($1.4 trillion) or more. Sadly, that looks more like an aspiration than a prediction. And because the EFSF bears the first losses, its capital is at greater risk of being wiped out than under a loan programme. This could taint France, which finances the rescue fund and has recently seen its AAA credit rating come under threat. Since the EFSF depends partly on France for its own credit rating, a French downgrade could undermine the rescue fund just when it is most needed.

If the foundations of the firewall are too shallow, then the bank plan plunges too deep. By the end of June 2012, banks are expected to establish a core-capital ratio of 9%. In principle, that is laudable. But if banks have months to reach their target, they can avoid raising new equity, which would dilute their shareholders, and instead move to the required ratio by shrinking their balance-sheets. That would be a terrible outcome: by depriving Europe's economy of credit, it would worsen the downturn.

Then there is Greece. Although the size of the writedown is welcome, euro-zone leaders are desperate for it to be "voluntary". That is because a default would trigger the bond-insurance contracts called credit-default swaps (CDSs). The fear is that a default could lead to chaos, because the CDS market is untested. That is true, but this implausibly large "voluntary" writedown will lead investors in other European sovereign bonds to doubt whether CDSs offer much protection. So while the EFSF scheme is designed to offer insurance to bondholders, the European leaders' insistence that the Greek writedown be voluntary will make euro-zone debt harder to insure.

…but trust is nowhere to be found

Europe has got to this point because German politicians are convinced that without market pressure the euro zone's troubled economies will slacken their efforts at reform (see page 63). Despite a list of promises presented to the summit by Silvio Berlusconi, Italy's prime minister (see page 66), Germany has good reason to worry. But it needs to concentrate on institutional ways of disciplining profligate governments, rather than starving the rescue package of funds. As it is, this deal at best fails to solve the euro crisis; at worst it may even make it worse. As the shortcomings of each component become clear, investors' fears will surely return, bond yields will rise and banks' funding problems will worsen.

Yet again, disaster will loom. And yet again, the ECB will end up staving it off. Fortunately, Mario Draghi, the ECB's incoming president, made it clear this week that he realises that is his job. But therein lies the tragedy of this summit. An ECB pledge of unlimited backing for solvent governments would have had a far better chance of solving the crisis months ago, and remains the best option today.

At this summit Europe's leaders had hoped to prove that their resolve to back the euro was greater than the markets' capacity to bet against it. For all the backslapping and brave words, they have once again failed. There will be more crises, and further summits. By the time they settle on a solution that works, the costs will have risen still further. ■

Is this really the end?

Unless Germany and the ECB move quickly, the single currency's collapse is looming

EVEN as the euro zone hurtles towards a crash, most people are assuming that, in the end, European leaders will do whatever it takes to save the single currency. That is because the consequences of the euro's destruction are so catastrophic that no sensible policymaker could stand by and let it happen.

A euro break-up would cause a global bust worse even than the one in 2008-09. The world's most financially integrated region would be ripped apart by defaults, bank failures and the imposition of capital controls (see pages 81-83). The euro zone could shatter into different pieces, or a large block in the north and a fragmented south. Amid the recriminations and broken treaties after the failure of the European Union's biggest economic project, wild currency swings between those in the core and those in the periphery would almost certainly bring the single market to a shuddering halt. The survival of the EU itself would be in doubt.

Yet the threat of a disaster does not always stop it from happening. The chances of the euro zone being smashed apart have risen alarmingly, thanks to financial panic, a rapidly weakening economic outlook and pigheaded brinkmanship. The odds of a safe landing are dwindling fast.

Markets, manias and panics

Investors' growing fears of a euro break-up have fed a run from the assets of weaker economies, a stampede that even strong actions by their governments cannot seem to stop. The latest example is Spain. Despite a sweeping election victory on November 20th for the People's Party, committed to reform and austerity, the country's borrowing costs have surged again. The government has just had to pay a 5.1% yield on three-month paper, more than twice as much as a month ago. Yields on ten-year bonds are above 6.5%. Italy's new technocratic government under Mario Monti has not seen any relief either: ten-year yields remain well above 6%. Belgian and French borrowing costs are rising. And this week, an auction of German government Bunds flopped.

The panic engulfing Europe's banks is no less alarming. Their access to wholesale funding markets has dried up, and the interbank market is increasingly stressed, as banks refuse to lend to each other. Firms are pulling deposits from peripheral countries' banks. This backdoor run is forcing banks to sell assets and squeeze lending; the credit crunch could be deeper than the one Europe suffered after Lehman Brothers collapsed.

Add the ever greater fiscal austerity being imposed across Europe and a collapse in business and consumer confidence, and there is little doubt that the euro zone will see a deep recession in 2012—with a fall in output of perhaps as much as 2%. That will lead to a vicious feedback loop in which recession widens budget deficits, swells government debts and feeds popular opposition to austerity and reform. Fear of the consequences will then drive investors even faster towards the exits.

Past financial crises show that this downward spiral can be arrested only by bold policies to regain market confidence. But Europe's policymakers seem unable or unwilling to be bold enough. The much-ballyhooed leveraging of the euro-zone rescue fund agreed on in October is going nowhere. Euro-zone leaders have become adept at talking up grand long-term plans to safeguard their currency—more intrusive fiscal supervision, new treaties to advance political integration. But they offer almost no ideas for containing today's conflagration.

Germany's cautious chancellor, Angela Merkel, can be ruthlessly efficient in politics: witness the way she helped to pull the rug from under Silvio Berlusconi. A credit crunch is harder to manipulate. Along with leaders of other creditor countries, she refuses to acknowledge the extent of the markets' panic (see page 64). The European Central Bank (ECB) rejects the idea of acting as a lender of last resort to embattled, but solvent, governments. The fear of creating moral hazard, under which the offer of help eases the pressure on debtor countries to embrace reform, is seemingly enough to stop all rescue plans in their tracks. Yet that only reinforces investors' nervousness about all euro-zone bonds, even Germany's, and makes an eventual collapse of the currency more likely.

This cannot go on for much longer. Without a dramatic change of heart by the ECB and by European leaders, the single currency could break up within weeks. Any number of events, from the failure of a big bank to the collapse of a government to more dud bond auctions, could cause its demise. In the last week of January, Italy must refinance more than €30 billion ($40 billion) of bonds. If the markets balk, and the ECB refuses to blink, the world's third-biggest sovereign borrower could be pushed into default.

The perils of brinkmanship

Can anything be done to avert disaster? The answer is still yes, but the scale of action needed is growing even as the time to act is running out. The only institution that can provide immediate relief is the ECB. As the lender of last resort, it must do more to save the banks by offering unlimited liquidity for longer duration against a broader range of collateral. Even if the ECB rejects this logic for governments—wrongly, in our view—large-scale bond-buying is surely now justified by the ECB's own narrow interpretation of prudent central banking. That is because much looser monetary policy is necessary to stave off recession and deflation in the euro zone. If the ECB is to fulfil its mandate of price stability, it must prevent prices falling. That means cutting short-term rates and embarking on "quantitative easing" (buying government bonds) on a large scale. And since conditions are tightest in the peripheral economies, the ECB will have to buy their bonds disproportionately.

Vast monetary loosening should cushion the recession and buy time. Yet reviving confidence and luring investors back into sovereign bonds now needs more than ECB support, restructuring Greece's debt and reforming Italy and Spain—ambitious though all this is. It also means creating a debt instrument that investors can believe in. And that requires a political bargain: financial support that peripheral countries need in exchange for rule changes that Germany and others demand.

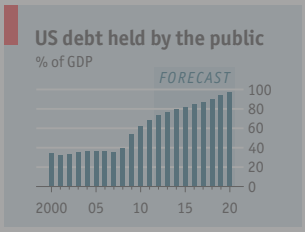
This instrument must involve some joint liability for government debts. Unlimited Eurobonds have been ruled out by Mrs Merkel; they would probably fall foul of Germany's constitutional court. But compromises exist, as suggested this week by the European Commission (see Charlemagne). One promising idea, from Germany's Council of Economic Experts, is to mutualise all euro-zone debt above 60% of each country's GDP, and to set aside a tranche of tax revenue to pay it off over the next 25 years. Yet Germany, still fretful about turning a currency union into a transfer union in which it forever supports the weaker members, has dismissed the idea.

This attitude has to change, or the euro will break up. Fears of moral hazard mean less now that all peripheral-country governments are committed to austerity and reform. Debt mutualisation can be devised to stop short of a permanent transfer union. Mrs Merkel and the ECB cannot continue to threaten feckless economies with exclusion from the euro in one breath and reassure markets by promising the euro's salvation with the next. Unless she chooses soon, Germany's chancellor will find that the choice has been made for her. ■

The supercommittee fails

A downgrade for Congress

By failing to agree on measures to limit the deficit, America's politicians have failed their country



IT WAS not a very ambitious target. All that the congressional "supercommittee" was required to do was to figure out a list of measures that would reduce America's budget deficits by $1.2 trillion over the next ten years. That sounds a lot, until you realise it is only 0.6% of GDP, not even a quarter of the $5 trillion or so that is really needed to right the books in Washington, and less than 3% of the $44 trillion that the federal government is expected to spend over that period. To reach a goal that a business cost-cutter would regard as desultory, the bipartisan committee of 12 senators and congressmen was accorded exceptional powers. Its work was to be subject to a simple up-or-down vote, with no possibility of amendment; and the Senate would not be able to use its power to filibuster. Yet on November 21st, after three months of deliberation, the team was forced to admit that it had failed.

On paper this failure might not seem to matter very much. Supposedly, spending cuts equivalent to the same $1.2 trillion figure will now automatically be triggered, starting in 2013, with $600 billion hacked out of the defence budget (see Lexington) and the other $600 billion coming from other non-mandatory categories of spending, including education, housing and environmental protection. But in reality the failure is deeply alarming, for several reasons.

First, it shows that Republicans and Democrats, even when offered the best possible conditions for dealmaking, can't do it. The Democrats refused to consider structural reforms to the big entitlement programmes (Medicare, Medicaid and Social Security). The Republicans refused to countenance anything that would see tax rates rise, even though no sensible analyst believes that the deficit (running at 8.5% this year) can be closed to a sustainable level by spending cuts alone, and even though ruling out any tax rises, even for people making more than $250,000 a year, is difficult to justify. Though a few interesting proposals were floated, suggesting that the Republicans were not totally immune to getting rid of loopholes (as long as any rate increases for the rich were off the table), they never came close to enjoying majority support. Until the political mood changes dramatically, it is impossible to see Congress tackling the deficit successfully—a process which will require reductions (through a combination of revenue increases and spending cuts) to the tune of four times what the supercommittee has just failed to deliver.

Second, the past few months have confirmed even more strongly the near-irrelevance of the president. A Ronald Reagan or a Bill Clinton would have been much more effectively engaged in twisting arms and, where necessary, dispensing favours. Barack Obama remained damagingly aloof throughout the supercommittee's fruitless deliberations. This should not have been surprising, given his lamentable failure a year ago to endorse the effective and brave conclusions of the Bowles-Simpson deficit commission that he personally appointed. But it does not bode well for the future—assuming that he has one, and is not turfed out of office in a year's time.

Third, this week's collapse sets up a nasty fiscal shock, to be administered in just five weeks' time. At the end of this year a temporary cut in the payroll tax is due to expire; so, too, are the extended unemployment benefits which are all that stand between millions of Americans and destitution. Folding an extension of these measures into the supercommittee negotiation was the best hope of preventing what could amount to around at least 2% of fiscal tightening next year. The chances of avoiding that tightening now look grimmer.

Finally, it is now clear that an almighty budget row will have to take place towards the end of next year, in the run-up to and immediately after the presidential election on November 6th. Congress will be trying to undo the supposedly automatic budget cuts it agreed to only in order to make it impossible for the supercommittee to fail: Mr Obama has said he will veto any such attempt. At the same time, the Bush-era tax cuts are set to expire, threatening a sharp tax rise for all income-tax payers, rich and middle-class alike, unless some sort of deal can be done. Expect more destabilising brinkmanship, just like the sort that attended the debt-ceiling crisis in the summer.

The not-so-bright side

There is, however, a last consideration. One reason why the supercommittee failed is that it felt no real sense of urgency. America is not Italy: this week, its ten-year government bonds were trading at a yield of well below 2%, the lowest levels for over half a century; as the euro moves towards disintegration, the attractions of Treasury bonds will only increase. But even that silver lining has a cloud: the corollary of this observation is that it will probably take a genuine, terrifying, American bond crisis to force the politicians to act. ■