# Prolonging the Agony: Europe's Sovereign Debt Crisis

William Leiss (12 September 2011)

When will the senior political and financial leaders in European countries come to their senses? When will they concede that their current policies to contain the debt crisis are not working and cannot be made to work? How long are they going to prolong the agony of waiting for the next wave of contagion to strike?

As *The Economist* noted recently (http://www.economist.com/node/21528266 ("Mountains to climb," September 3rd), September and October 2011 will be critical months for Europe. Among other things, Italy has to roll over $62bn in bonds during September, and more the following month. Meanwhile the Italian government dodges and weaves in an attempt to maintain the credibility of its announced spending reductions. The situation in Greece worsens by the day, as the relentless downward spiral of austerity measures, sinking GDP, and widening budgetary deficits continues its inevitable course; investors now assume a 90% risk of default on Greek bonds. France's largest banks are under pressure from the ratings agencies, in part due to their large holdings of Greek bonds. And in Germany the political pressure from citizens against new bailouts in southern-tier countries continues to mount.

As I noted in my August 12 blog, "Difficult risk-risk tradeoffs" (http://leiss.ca/wp-content/uploads/2011/07/Risk-Risk-Tradeoffs.pdf ), the rising political rhetoric may be the most dangerous development of all. The line is simple: Countries can have bailouts if and only if they promise to implement stringent austerity measures, eliminating budgetary deficits as soon as possible so that they can begin repaying their borrowings. This theme was reiterated at last week's G7 meeting, including by our own Jim Flaherty. These measures lead to declining government expenditures, declining tax revenues, and higher unemployment, as the economy contracts. Governments are urged to try to escape this conundrum by raising new types of tax revenue; but in countries like Italy and Greece, lack of compliance with all forms of tax collections is a way of life, and it beggars belief to suggest that this behaviour can be changed over the short term. So the politicians make increasingly strenuous promises of adherence to austerity programs as the floor collapses beneath their feet.

More radical measures are needed to stop the debt crisis from further damaging both Europe and the rest of the world. The problem of contagion must be defeated.

As a number of people have argued, Greece may be already too far gone. It should be considering the option to leave the Euro zone, default, endure the resulting decade-long economic shock, and begin to rebuild their economy on a sounder footing. Holders of

Greek bonds will have to take a 50-60% haircut on their investments (for European banks, a loss of $100bn or more). As I suggested in the August 12 piece, European governments could use the monies allocated for the second round of Greek bailouts to absorb these costs instead, with the added benefit to Greece (eventually) of having less money to repay.

But this will only work if the EU at the same time draws a line in the sand – otherwise the contagion will quickly bring down others. There is only one line that will work: an announcement that the Eurozone intends to reissue its collective debt in Eurobonds.

A splendid recent essay by the University of Leuven's Paul de Grauwe, "The Governance of a Fragile Eurozone," recommended in a Paul Krugman column in *The New York Times,* has made the case for this strategy (http://www.ceps.eu/book/governance-fragile-eurozone ). The author's case takes into account the need to deal with the moral hazard problem – profligate countries issuing lots more national debt because it will be cheaper to do so – with the appropriate strategies. (In a nutshell, no country's Eurobonds can exceed 60% of its GDP; the rest will be in national bonds carrying a significantly higher interest rate, acting as an incentive to limit debt.) There is also a mechanism, based on varying levels of issuance fees, designed to compensate countries like Germany, which can presently issue debt at low interest rates, for the increased rates that Eurobonds will carry. It is even possible that Greece could be able to participate in this program and thus stay in the Eurozone, if that should turn out to be a better strategy than default.

The move to Eurobonds is likely to be the first of a number of steps that leads to more budgetary integration among countries in the Eurozone. Recent events have shown that this will be necessary if the monetary union is to survive. But does the political will exist to get this done? *What Europe's leaders will have to do, in order to free up this possibility for themselves, is to engage in a sustained dialogue and communications effort with their own citizens.*

They will have to confront the political problem head-on: This is not about allowing miscreants and loose Southern spenders to get away with living it up while sober Northerners save their money for a rainy day. This is about telling the truth, namely, that (as de Grauwe shows) it is the current form of the Eurozone itself – a monetary union without a fiscal one – that is primarily responsible for the contagion risk in the European debt crisis. [The alternative narrative does not explain why Spain is at risk, since at the outset of the crisis it had one of the lowest debt-t0-GDP ratios in all of Europe.]

The dialogue with citizens is needed to help them understand that the instinct to punish those who are now in financial trouble is counterproductive. They must be helped to see that they too have benefited substantially from the creation of the common currency, and that allowing this experiment to fail is not in their interest in the long run. Above all, they must be helped to understand which are the options that will solve the current crisis on a sustainable basis and which are not.

This type of dialogue and communications effort cannot be carried off with a few offhand remarks following another summit meeting between Merkel and Sarkozy. It must be carefully prepared, sustained over time, participated in by the representatives of all Eurozone countries, and clearly have the imprimatur of all of the political leaders. A very thorough effort must be made to explain the technical details of the various options in a language that is understandable by the majority of citizens.

Europe has already experienced one major failure in communications and dialogue on a broad social issue, namely, the implications of multiculturalism and the integration of new populations and cultural traditions into European civilization. It cannot afford another.

*Other reading:*

"Europe's Sovereign Debt Crisis,*" *The New York Times,* updated to 12 September 2011: **http://tinyurl.com/3e8jbkx**

*including many examples of splendid journalism by Liz Alderman and others