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Europe's Financial Woes, Again

On October 26 the highest European political leaders held a summit with the objective of stabilizing financial markets, which had become turbulent around the uncertainties surrounding outstanding debt of several European governments, above all Greece, but extending to Italy and even to Belgium and France. The summit succeeded, at least in the short run. Financial markets responded positively to the fact that European leaders at least were able to reach agreement on what on the surface appeared to be a significant package of support for Greece and in future for other eurozone countries in financial difficulty. France's stock market (CAC) index rose by six percent, an extraordinary rise in a single day.

This summit was the tenth since early May 2010 to deal with European financial turbulence that started with Greece two years ago, in late 2009. The problem was high levels of government (sovereign) debt combined with continuing budget deficits. Governments must go to financial markets both for new debt and to refinance maturing debt. Willing buyers have become scarcer, both for sovereign debt and for debt by banks that are large holders of sovereign debt.

Until mid-2007, bond markets did not distinguish much among euro-denominated sovereign bonds from different countries. Now, outstanding Greek bonds are priced to yield 25 percent, and Italian bonds at 6 percent, compared with German bonds at 2 percent – an enormous range, reflecting anxiety about the economic prospects and fiscal management of several European countries

The October 26 agreement had three main components:

1) Relieve Greece of some of its debt, by calling on private holders of Greek bonds voluntarily to cut their claims by 50 percent in exchange for new, guaranteed bonds, which of course must be negotiated with the holders of the bonds. The voluntary nature of the haircut is to avoid triggering payment on credit default swaps, whose total magnitude and distribution are not known.

2) Require weakly capitalized European banks to raise 106 billion euros in new capital during the next twelve months, valuing their holdings of euro sovereign bonds at market rates that prevailed on September 30.

3) Envisioning a leveraging of the 440 billion euro European Financial Stabilization Fund (EFSF) to over one trillion euros to permit it to deal with potential sovereign debt problems in Spain and Italy, countries much bigger than Ireland and Portugal, which have already drawn on the EFSF – but without requiring additional budgeted funds. (Italian debt alone is 1.6 trillion euros.) Details of this leveraging are to be worked out, and considerable skepticism has already been expressed about whether a workable formulation can be found.

Solution to the Greek problem – and possibly to other countries – requires three elements. First, Greece must receive debt relief, since servicing the anticipated debt equal to 186 percent of GDP at any plausible interest rates will be impossible. Second, new loans must be supplied to Greece to cover its continuing (although declining) budget deficits and also (rarely mentioned) to cover its current account deficit. Third, Greece must take actions to persuasively reduce and eventually eliminate those borrowing needs, a condition necessary to assure new sources of funds, which must come mainly from official bodies (including the International Monetary Fund). The October 26 agreement provides for debt relief (albeit perhaps not enough) and acknowledges the need for new borrowing, probably double the additional 100 billion euros agreed in July. The Greek government has accepted the need for additional deficit-reducing cuts in expenditure and increases in taxes. But Prime Minister Papendreou surprised everyone by announcing in Athens, after the summit, that he would put his program to a referendum by the Greek voting public, a risky strategy. Financial markets reacted adversely, reversing the gains immediately following the summit and deepening the discount on Greek and Italian bonds.

As noted, financial markets initially reacted well – but more to the fact of political agreement among heretofore bickering leaders than to the content of the agreement, critical details of which remain to be resolved. Moreover, the agreement itself does not represent a long-term solution. It is another in a sequence of expedient reactions to unfavorable market developments, at minimum budgetary and political cost in the financially stronger members of the eurozone. At the end of the day, it will be up to the European Central Bank (ECB), which can issue euros through its own purchases, to prevent bond markets from collapsing. Wilhem Buiter, chief economist at Citibank, has estimated that the ECB could buy as much as 3 trillion – more than the entire Spanish and Italian sovereign debt together – without triggering serious inflationary pressures. It has been criticized for buying any government bonds at all, and the German member of its Board resigned over the issue. But it represents a more secure potential support for the larger countries than can any conceivable manipulation of the EFSF.

While still trying to deal satisfactorily with this crisis, the European Union will wrestle with how to prevent the next crisis. Its representatives will meet in December to discuss changes in its treaties that will place member governments under greater fiscal discipline, so a Greek-style crisis cannot be repeated. If successful, this would represent another step toward a more united Europe. But it would also represent another step away from legitimacy with the European public. Public expenditures and taxation are at the heart of modern parliamentary democracy. Empowering Brussels to dictate or override national parliamentary decisions runs the risk of undermining support for the European Union among European citizens.