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This is not the way to solve the eurozone debt crisis

By David Roche
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The aim of the emergency European Union financial stabilisation package was to create "shock and awe" in financial markets. It is designed to convince markets that they cannot win in forcing any eurozone state into defaulting on its debt.

Initially, markets may be wowed by the size of the package. But the size just means that more debt has been added to a problem that is about too much debt. EU governments and the European Central Bank are now obliged to guarantee or buy the sovereign debt of other members as a solution to the eurozone's debt crisis. But the solution to a hangover is not more alcohol.

The shock of this package will eventually give way to less awe. As all the AAA-rated nations in Europe have 70-80 per cent of gross domestic product public debt ratios already - not far behind the "junk bond" states (and worse than Spain), we reckon the market will soon wake up to the fact that this deal is a form of contagion by official action.

This package is not the circuit-breaker to end the crisis because it involves the creation of more sovereign debt to solve the problem of too much. It is a story that we have outlined for the whole of the Organisation for Economic Co-operation and Development.

As we explained in our book, *Sovereign DisCredit!* *, the world is facing a sovereign debt crisis that will squeeze economic growth and possibly deliver a series of debt default events down the road. Sovereign debt issuance is sucking up 25 per cent of available world savings and that will squeeze the ability of the private sector to invest in productive opportunities. And there is a wide body of empirical research from the IMF, the BIS and the work of Carmen Reinhart and Ken Rogoff that suggests when sovereign debt hits these sorts of levels in so many large countries, it curbs long-term economic growth well below trend and could lead to debt defaults.

The EMU crisis is a harbinger for the future elsewhere. Average sovereign debt in the eurozone will be about 85 per cent this year and the eurozone will run an average budget deficit of about 6.5 per cent in 2010. That's bad enough. But it is lower than in the UK, the US and Japan. UK sovereign debt to GDP will surpass that of the eurozone average by 2011, as will the US, while Japan's is more than double. The US and UK budget deficits will be in double digits this year and probably next.

What investors must focus on is the conditionality of the loans and guarantees. If the profligate and high-debt governments of Greece, Portugal, Spain, Ireland (and perhaps even Italy and Belgium down the road) can get away with soft conditions for getting EMU financing, the euro will suffer for some time. So will all sovereign debt in the eurozone.

It certainly does not augur well that the ECB has been browbeaten into buying sovereign debt to help the junk-bond status of some EMU governments. This can only debase the euro down the road and introduce ECB-sponsored moral hazard.

The ECB move is an earthquake that marks a definitive divorce of ECB policy from all Bundesbank best practice. The bank is directly intervening in sovereign bond markets to distort the price of risk in order to finance the budget deficits of profligate countries. In that sense, bond prices will no longer reflect sovereign risk.

However, if the fiscal terms for the new facilities are tough, then the main issue is unchanged: namely, can these countries deliver fiscal austerity without restructuring their debt? That depends on the Germans ensuring that any terms for financing will be kept to.

Germany has reluctantly had to accept this emergency package. Germany managed to avoid a limitless guarantee, regardless of the costs and got external support from the IMF as part of the deal, rather than relying on just European funds, as the other eurozone member states had argued.

There were some modest new belt-tightening moves from some of the countries affected by contagion yesterday, but there is much further to go. So, in effect, all this extra debt and funding has been offered on good faith only. Berlin had to accept an increase in the existing ceiling for issuing eurobonds, something the Germans have always been against.

But the Germans will insist that any funds handed out to profligate EMU states must be on the basis of conditions agreed with the IMF and the EU Commission. Europe's fiscal war is only just beginning.

The real worry is that the eurozone debt crisis may seem like a tea party if the contagion spreads to the US, the UK and Japan. The UK has no effective government in prospect that can start to deal with its fiscal crisis, while the Japanese and US governments are in denial about the extent of their debt burden. Tighten your seat belts.

David Roche is president and global strategist at Independent Strategy

**David Roche and Bob McKee, Sovereign DisCredit!, published by lulu.com*