The Economist

The euro area's debt crisis

Sovereign remedies

The “grand bargain” may prove less grand in reality than in rhetoric

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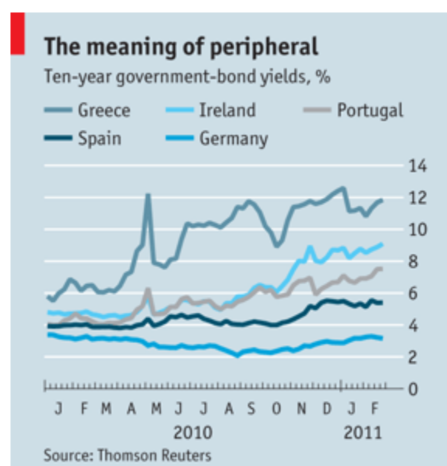
FOR months now European leaders have been striving to get on top of the euro-area debt crisis. But as the deadline for a supposedly comprehensive and enduring solution nears—summits are due to be held on March 11th and March 24th—the “grand bargain” is looking ever less grand. A disappointing outcome will fuel market doubts about the fiscal sustainability of the most troubled euro-area economies. Those doubts remain intense. Ten-year bond yields are sky-high for Greece and Ireland, despite the bail-outs of 2010; at an intolerable level for Portugal, generally seen as next in line for a rescue; and still worryingly high for Spain (see chart).



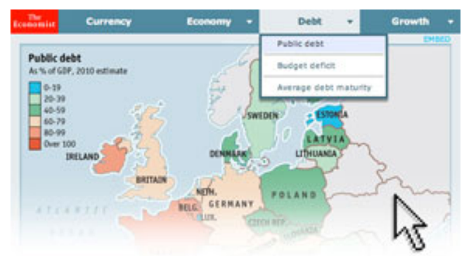
This being a sovereign-debt crisis, politics has a habit of upsetting the tidy reckonings of market spreadsheets. The Irish election on February 25th may have delivered the predicted outcome in the shape of a new ruling coalition dominated by Fine Gael. But it also injects fresh uncertainty since Enda Kenny, the new Irish leader, has a popular mandate to revisit some of the terms of the bail-out in November. The outcome of his negotiations—chiefly with Germany, the euro area’s reluctant paymaster—will in turn help shape a permanent debt-restructuring mechanism that will replace the European Financial Stability Facility (EFSF) when the interim rescue arrangements expire in mid-2013.

Politics has intruded in Germany, too. Angela Merkel's ability to face down domestic opposition to a deal involving big German concessions has been undermined by the drubbing her party took in a recent regional election, and by the forced departure of her defence minister. Awkwardly, the chancellor faces an even more vital verdict from voters, in the big state of Baden-Württemberg, on March 27th, just after the second European summit.

Only one firm decision has so far been made in the run-up to the summitry: that the European rescue funds announced last May will actually match the original promise of €500 billion ($690 billion). Hopes that the EFSF could be used to facilitate a voluntary reduction in debt, notably Greece's towering 140% of GDP, have dwindled. The idea was that it could lend funds to Greece, which would buy back its debt at market prices—ie, at a deep discount to its par value.

On a recent visit to Berlin, George Papandreou, the Greek prime minister, pleaded for such buy-backs to be on the negotiating table. But German opposition to the notion has hardened. In late February, for instance, the Bundesbank, the country's central bank, condemned the idea as an opaque inter-governmental transfer.

Whether buy-backs would help is in any case unclear. As Nouriel Roubini and Brad Setser, two economists, argue in "Bail-outs or Bail-ins?", a book drawing on the experience of debt crises in emerging economies, a determined programme to repurchase bonds would drive up their price, so reducing any relief. Removing debt held by private holders and replacing it with strict obligations to the EFSF could make an eventual restructuring harder, should that prove unavoidable.



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Whereas excessive public debt in Greece has arisen from years of public profligacy, Ireland's problem has been made acute by the unbearable cost of propping up its oversized and undercapitalised banks. This amounts to at least 36% of GDP, according to Dermot O'Leary, an economist at Goodbody Stockbrokers, helping already to push public debt to almost 100% of GDP. A possible target for write-downs by the new government is the €21 billion of bank debt (worth 13% of Irish GDP) not covered by state guarantees. But that option is steadfastly opposed by the European Central Bank, which fears it might rock a euro-area banking system that is still far from healthy.

A more realistic objective for Mr Kenny is to bring down the interest rates on the bail-out funds. These were reckoned at the time of the deal in late November to average 5.8% on the €67.5 billion of external support, two-thirds of which comes from European sources (the remainder is from the IMF). The funding, which has an average maturity of 7.5 years, will protect Ireland from having to borrow in the markets over the next three years. But the Irish will press for a reduction of as much as two percentage points on the European funds, arguing that this high cost of borrowing was originally devised for a serial fiscal offender like Greece rather than a country whose public finances have been laid waste by an unfortunate banking accident.

How much would lower rates help? David Mackie, an economist at JPMorgan Chase, argues that the real prize would be to offer low-cost finance beyond 2013. Otherwise, if Greece and Ireland have to return to the markets, they will have to pay punitive rates that would keep their debt burdens rising even if they are running primary (ie, excluding interest payments) budget surpluses by then. But even if such a concession was achieved, the point at which debt would peak would still be very onerous—over 150% of GDP for Greece and around 125% of GDP for Ireland.

Moreover, securing a more favourable interest rate will be tough. The Bundesbank, for example, is no keener on the idea than it is on bond buy-backs. Other parts of the grand bargain are also in trouble: German proposals to impose Teutonic discipline on the flakier members of the euro area have sparked plenty of opposition. Indeed, some insiders are now saying that European leaders will not be able to resolve their differences in March.

Fears of an adverse reaction in the markets—Portugal’s position is looking precarious, with bond yields exceeding the unsustainable level of 7% over the past month—should focus minds enough to produce an agreement. But it looks unlikely to be enough to get ahead of the crisis.

A more fundamental rethink is needed. It may be better to bite the bullet of default, starting with Greece. A recent report from Bruegel, a think-tank, concluded that Greece had become insolvent, called the current wait-and-see approach “a dubious strategy” and said that restructuring was necessary. The main objection to such a policy is the risk of destabilising the European banking system. But that risk could be contained, the authors argued, if banks’ weaknesses were addressed following new stress tests, which get under way this month and whose results will be published in June. The idea of resolving the debt crisis through restructuring may still be anathema in official European circles, but it won’t go away.

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