

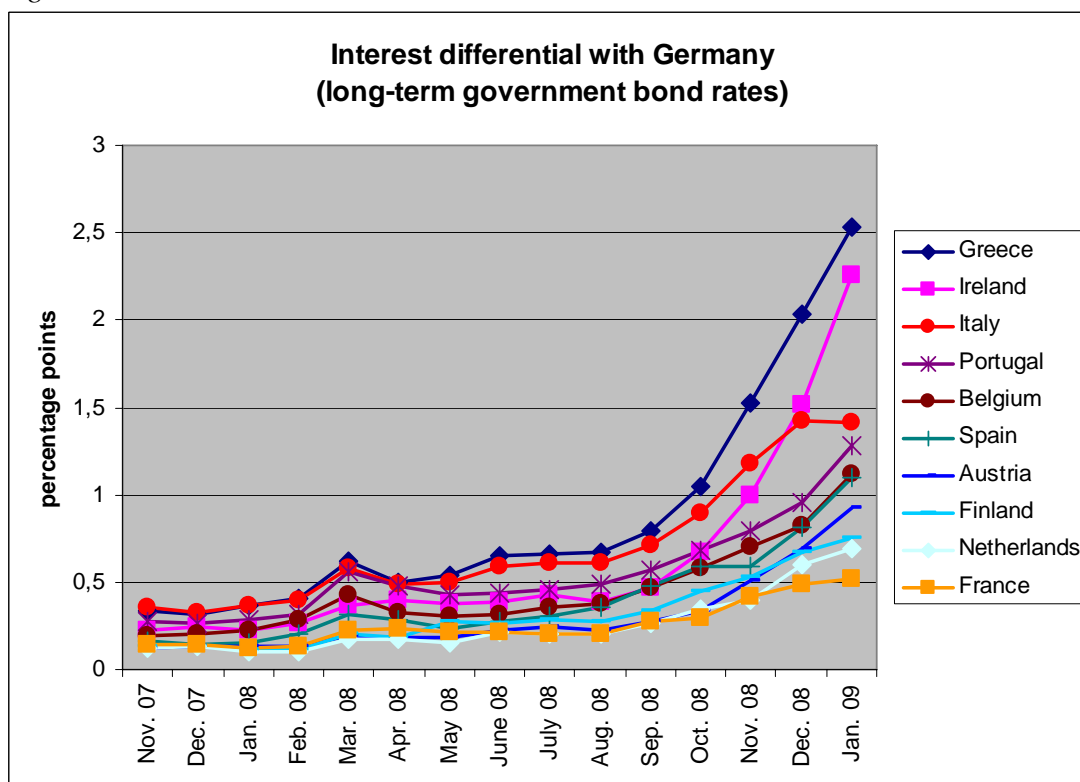
Why should we believe the market this time?

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Spreads of sovereign debt within the eurozone have increased dramatically over the past few months. Figure 1 shows the evidence. The governments of Greece and Ireland now (February 2009) pay an interest rate on their debt that exceeds the German government bond rate by more than 200 basis points, while the governments of Spain, Portugal and Italy have to pay more than 100 basis points extra.

Figure 1.



Source: ECB, <https://stats.ecb.int/stats/download/irs/irs/irs.pdf> and FT for Jan 09.

Since all these bonds are expressed in the same currency, the euro, these spreads reflect a pure default risk (assuming that the German bonds are free of default risk). Thus the market now takes the view that the governments of these countries will default on their debt in the foreseeable future.

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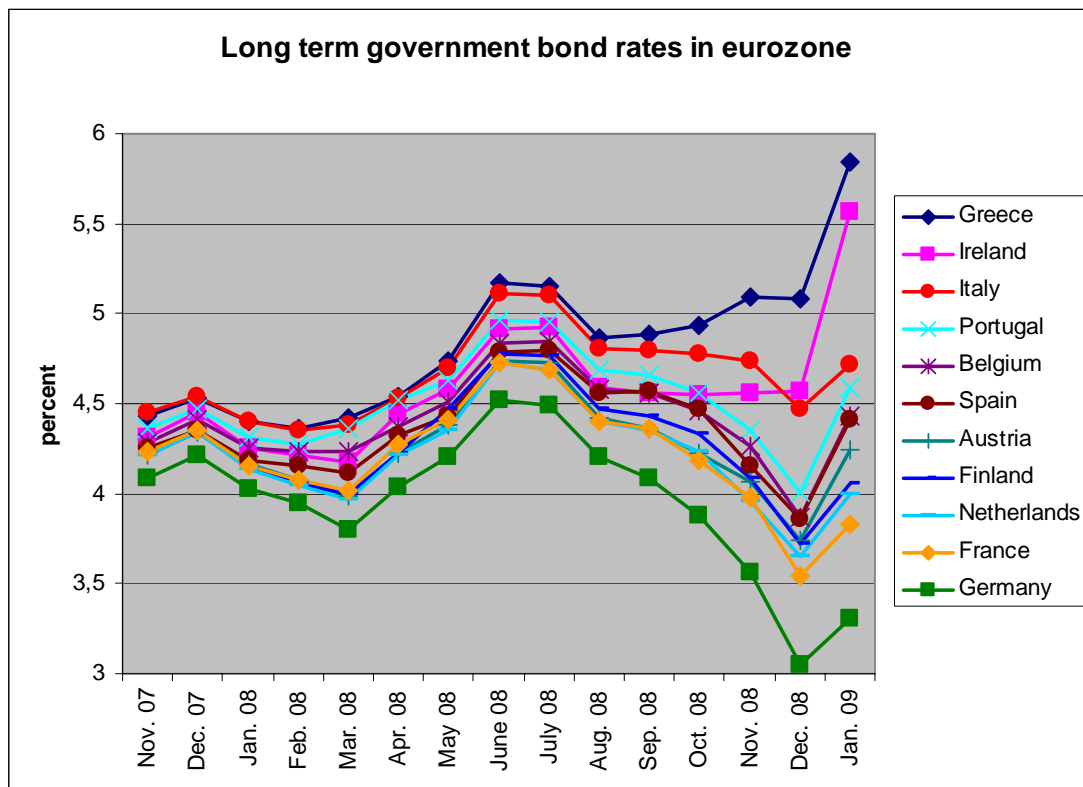
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How reasonable is such a forecast? It will remain difficult to answer that question. The fact that none of the Western European countries have defaulted on their debt in the last 60 years does not preclude that they will do so in the next 50 years. It is difficult to understand, however, why the market (and the rating agencies) forecast a default of the Spanish government debt, while it does not make such a forecast for the UK, which has experienced a similar buildup of its debt as Spain and whose banking problem is more serious than Spain's.

My hypothesis is that the widening bond spreads within the eurozone are the result of panic in the financial markets. The panic that followed the banking crises has led investors into a stampede away from private debt into assets that are deemed safe. These are mainly government bonds of a few countries that are perceived to provide safety. The US, Germany and possibly France are a few of these countries that for some strange reason have been singled out as supplying safety. Other countries do not profit from the same 'panic flight to safety'. This is shown in Figure 2, which presents the levels of the government bond rates in the eurozone. We observe a significant decline of the German government bond rate by close to 100 bp. Surely it cannot be the case that holding German bonds in February 2009 is significantly less risky than a year earlier. But Germany was singled out by the market as the country that provided safety. France also benefitted from this, but less so. With the exception of Greece and Ireland, the other countries kept their bond rates more or less unchanged (compared to a year ago) suggesting that these countries were bypassed by panicky investors. Only Greece and Ireland saw their bond rates increase significantly over the last year, suggesting that the increased spreads of these countries are not only due to panic.

Figure 2.



Source: ECB, <https://stats.ecb.int/stats/download/irs/irs/irs.pdf> and FT for Jan 09.

Panic is never a good guide for risk analysis. It distorts prices and gives wrong incentives. During the decade preceding the eruption of the financial crisis in August 2007, rating agencies and market participants, gripped by euphoria, systematically underestimated the risk inherent in a wide range of financial assets. Today the panic that has gripped them leads to an equally distorted view of the risks involved. Private debt is dumped in favour of government debt of just a few countries. How these countries are selected is unclear. This selection mechanism is the result of an emotional reaction that leads market participants to believe that “it is inconceivable that serious countries like the US, Germany or France would ever default on their debt” while other countries are deemed to be to be capable of doing such a bad thing. These emotional reactions create distortions that affect economic activity in profound ways.

More specifically, the interest rate spreads faced by southern European countries and Ireland are giving the governments of these countries incentives to reduce their efforts to stabilise their economies. Extra spending which leads to higher deficits is punished by a higher interest cost, discouraging these countries to stimulate their economies. No such penalties are imposed on Germany and France.

In addition, these spreads create a perception of future default crises and impending fiscal doom, which impacts on the effectiveness of budgetary policies. We know that fears of future default crises reinforce the ‘non-Keynesian’ effects of fiscal policies, i.e. when agents fear such future crises, they are more likely to react to budgetary stimulus by increasing their savings (see the well-known paper of Giavazzi & Pagano, 1996). As a result, budgetary stimulus packages lose their effectiveness.

The penalties imposed by increasing spreads on southern European countries and Ireland also create negative externalities. For example, the rescue of banks in these countries is more expensive than in the rest of the eurozone, making it more difficult to resolve the banking crisis in these countries. This is likely to lead to further weakening of economic activity in these countries with possible feedback again on the banking system, on the government budget deficits and on the ratings applied by the rating agencies.

How should one deal with these distortions and externalities?

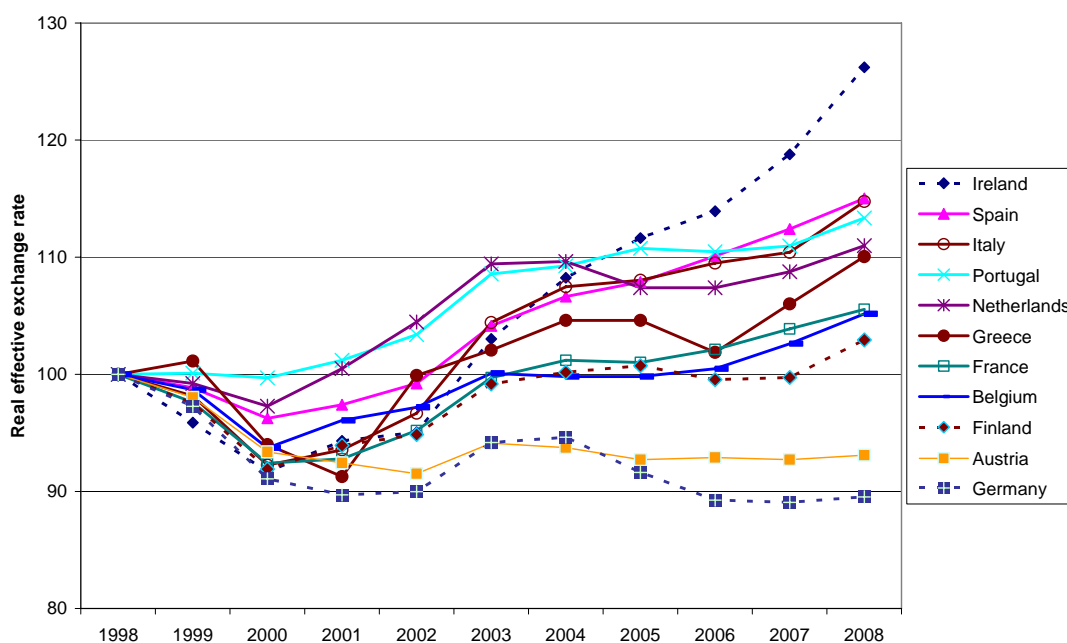
It will remain difficult to prevent cycles of euphoria and panic from affecting perceptions of risk in the markets. Authorities can, however, attempt to offset the distorting effects these cycles produce. The European Central Bank, in particular, has the tools to do just that. Here is my proposal. As the ECB will be forced very soon to engage in quantitative easing, it will be buying long-term assets, in particular government bonds. It should at that moment, privilege the buying of Irish, Greek, Spanish and Italian government bonds. In doing so, it would increase the price of these bonds and reduce their yields. Thus such a quantitative easing would tend to reduce the spreads in government bonds in the eurozone, and would eliminate the distortions and the externalities that these spreads create. It would also make it possible to stimulate the economies of all eurozone member countries, benefitting the whole area.

Clearly this proposal will meet with much resistance. We now increasingly hear the story that the market is punishing profligate governments, and rightly so. But why should we trust the market judgments any better now than five years ago when the same market (orchestrated by rating agencies) completely misjudged the risks that existed in the financial markets? When the market was so wrong in the past, why should we believe it now and accept its verdict? We should not. The spreads that have been created

within the eurozone are largely the result of panic. We can and should correct for the distortions and externalities this is creating.

This being said, it remains the case that Spain, Ireland, Italy and Greece face important adjustment problems. These countries have experienced relatively high wage and price inflation in the last ten years leading to a loss of competitiveness. This is shown in Figure 3. Part of the higher domestic price and wage inflation may be due to the Balassa-Samuelson effect, but this is unlikely to be the case in all these countries. Spain and Italy, for example, have experienced sluggish productivity growth. It follows that these countries will have to go through a period of adjustment aimed at redressing their competitive position, very much like Germany did during the first five years of the eurozone. This will be a painful process. The overriding problem these countries face today, however, is the same as everywhere else, i.e. how to counter the deflationary effects of the financial crisis. There is no reason why these countries should be singled out to be punished. This punishment will make it more difficult to adjust to the deflationary dynamics. It will also not help them in regaining their competitive positions.

Figure 3. Relative unit labour costs in the eurozone



Source: European Commission, European Economy.

Reference

Giavazzi, Francesco and Marco Pagano (1996), "Non-Keynesian effects of fiscal policy changes: International evidence and the Swedish experience", *Swedish Economic Policy Review*, May.