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Europe's Monetary Cordon Sanitaire

WASHINGTON, DC – German Finance Minister Wolfgang Schäuble likes to criticize other governments, including that of the United States, for their "irresponsible" policies. Ironically, it is the German government's loose talk that has brought Europe to the brink of another debt crisis.

The Germans, responding to the understandable public backlash against taxpayer-financed bailouts for banks and indebted countries, are sensibly calling for mechanisms to permit "wider burden sharing" – meaning losses for creditors. Yet their new proposals, which bizarrely imply that defaults can happen only after mid-2013, defy the basic economics of debt defaults.

The Germans should recall the last episode of widespread sovereign default – Latin America in the 1970's. That experience showed that countries default when the costs are lower than the benefits. Recent German statements have pushed key European countries decisively closer to that point.

The costs of default depend on how messy things become when payments stop. What are the legal difficulties? How long does default last before the country can reach an agreement with its creditors? How much more must it pay for access to debt markets later?

The benefits of default are the savings on future payments by the government – especially payments to non-residents, who cannot vote. This obviously depends in part on the amount of debt outstanding, the interest rate, and the country's growth prospects if it continues to pay.

Countries that are near the point where "can't pay" becomes "won't pay" have high interest rates relative to benchmark "safe" debt issued by other governments, because even small shocks can shift the balance for decision-makers towards default. But these interest-rate spreads make the benefits of non-payment greater, so the same shocks can send a country quickly into default.

Seen in these terms, it is clear why the German government's proposed debt-restructuring mechanism immediately shifts weaker eurozone countries towards default. As Chancellor Angela Merkel and her colleagues promote their well-defined plan – which comes in addition to a plan for bridge financing while in default – the cost of default falls. Moreover, the benefits rise, because the restructuring clauses required for new debt, together with Germany's highly visible efforts to avoid future government bailouts, raise the interest-rate spreads that weaker countries must pay today.

Bond-market participants naturally turn now to calculating "recovery values" – what creditors will get if countries default today. For example, Greece's debt stock, including required bridge financing under the IMF program, should peak at around 150% of GNP in 2014; much of this debt is external. If a country can support debt totaling 80% of GNP (a rough but reasonable rule of thumb), then we need approximately 50% "haircuts" on this existing and forthcoming debt (reducing it to 75% of its nominal value).

However, of this 150% of GNP, at least half is or will be official in some form. If it is fully protected, as seems likely (the IMF always gets paid in full), then the haircut on private debt rises to an eye-popping 90%. And this leaves out government spending that may be needed for further recapitalization of Greek banks.

For Ireland, too, sovereign debt, including bridge financing, will rise close to 150% of GNP by 2014, and is mostly external. But a sovereign default would require a much larger bank bailout than in Greece, potentially leaving private debt almost worthless if official debt has seniority. Total haircuts don't happen historically – except in the wake of communist takeovers – but it is hard to imagine that private creditors won't suffer huge losses in net present value.

Given this, we should expect Greek debt yields to rise further, despite the current IMF program. Likewise, an IMF program for Ireland – which seems increasingly likely – will not bring down domestic bond yields and reopen credit markets to any kind of Irish borrower.

If people start to think this way, Portugal, whose already high and growing debt is held largely by non-residents, becomes a candidate for default as well. In that case, it makes little sense to hold Spanish debt, either, which is also mostly external. Spain's financial exposure to Portugal and its housing-led recession don't help matters.

And, if Spain is at serious risk of default, government solvency is at risk throughout the eurozone – except in Germany. Perhaps Italy can survive, because most of its debt is held domestically, which makes default less likely. But the size of Italy's debt – and of Belgium's – is worrisome.

Given the vulnerability of so many eurozone countries, it appears that Merkel does not understand the immediate implications of her plan. The Germans and other Europeans insist that they will provide new official financing to insolvent countries, thus keeping current bondholders whole, while simultaneously creating a new regime after 2013 under which all this debt could be easily restructured. But, as European Central Bank President Jean-Claude Trichet likes to point out, market participants are good at thinking backwards: if they can see where a Ponzi-type scheme ends, everything unravels.

In effect, the European Union and the ECB are now being forced to return with overly generous support to the weak countries – including buying up all their debt, if necessary. Otherwise, a liquidity run would create solvency problems for all the big eurozone debtors.

Drastic action is needed to prevent European bond markets from drying up. Trichet has said repeatedly that current ECB interventions do not target interest rates. So the ECB should decide which countries are inherently solvent, and then protect them against a liquidity squeeze with new, scaled-up interventions that *do* target interest rates.

At a minimum, the ECB will probably need to match the $1 trillion annual US rate of quantitative easing, and front-load much of it. The euro will fall, and Trichet will miss his inflation target. But Germany will boom.

At that point, the Europeans should get on with completing their monetary *cordon sanitaire*: orderly debt restructuring in all countries with debt burdens that are too large to be credibly restructured in Merkel's new regime.

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