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Greek Myths and the Euro Tragedy

Letting someone lose money on sovereign debt is the acid test for the euro.

By JOHN H. COCHRANE

Last week the Greek bailout ballooned into a gargantuan 750 billion euro (nearly $1 trillion) debt stabilization fund, including a $39 billion line of credit from the International Monetary Fund. This coincided with the European Central Bank (ECB) announcement that it would immediately begin purchasing junk-rated Greek debt.

It won't work. The problem isn't liquidity, psychology or speculators. Germany and France simply cannot borrow or tax enough to cover Europe's debts and looming deficits. So, barring a fiscal and growth miracle, we will either see sovereign defaults (larger and more chaotic for having been postponed) or the ECB will have to print euros to buy worthless debt, leading to widespread inflation. Since inflation lowers the value of promises to state workers and pensioners, and also is easy to blame on others, it will be an especially tempting escape.

Notice who is missing: Greek bondholders are not being asked to miss a single interest payment, reschedule a cent of debt, suffer any write-down, take a forced rollover or conversion of short to long-term debt, or any of the other messy ways insolvent sovereigns deal with empty coffers. Those who bought credit default swaps lose once again.

But why? The reasoning behind the Greek bailout is founded on several myths that need exploding:

• *Saving the euro.* We're told a Greek default would imperil the euro. The opposite is true. Allowing Greece to default, or to renegotiate with bondholders, would be the best way to save the euro. A currency union is strongest without fiscal union. Then countries are no different from companies. If they borrow and cannot pay back, investors lose money. The currency is unaffected.

The euro could become a monetary union with full fiscal union. I hate to think what EU budgets and taxes would look like if they were all run from Brussels, but at least that system might impose some discipline on national governments' incentive to borrow, spend, and demand bailouts.

But the euro will be a disaster as a monetary union with loose fiscal controls and constant speculation about will-they-or-won't-they (or can-they-or-can't-they) trillion-euro bailouts and ECB financing. The Europeans have found the worst possible combination.

How did this happen? The euro's founders wrote rules against sovereign bailouts. They almost created a perfect currency: an international standard of value and medium of exchange, with a central bank mandated only to maintain a stable price level. The euro was not to be devalued to wipe out government debts or to gain temporary (and often illusory) trade or employment advantages. In the next U.S. inflation crisis, the euro might have succeeded the dollar as the international reserve currency.

But the euro's founders also set debt and deficit limits. The problem is not that these limits were too loose. The problem is having them at all. The mere existence of the limits says, in effect, that politicians will have a hard time resisting bailout pressure. So the markets lent at low rates and gave high bond ratings. The EU rediscovered that it's much harder to grow a spine in the middle of a crisis.

The euro founders should have said instead, "Go ahead, use our currency if you like. Rack up any debts you want. We don't care, because we are not going to bail you out—we've set it up so we can't bail you out. Bond buyers beware."

The euro founders never decided whether they were creating the perfect currency without fiscal union, or if they were creating a fiscal union on the way to political union. They never decided if the euro was going to be the national currency for a future United States of Europe or a gold standard for the modern age. Now they have neither.

• *Contagion*. We're told that a Greek default will lead to "contagion." The only thing an investor learns about Portuguese, Spanish, and Italian finances from a Greek default is whether the EU will or won't bail them out too. Any "contagion" here is entirely self-inflicted. If everyone knew there wouldn't be bailouts there would be no contagion.

• *Systemic risk*. We're told that a Greek default will threaten the financial system. But how? Greece has no millions of complex swap contracts, no obscure derivatives, no intertwined counterparties. Greece is not a brokerage or a market-maker. There isn't even any collateral to dispute or assets to seize. This isn't new finance, it's plain-vanilla sovereign debt, a game that has been going on since the Medici started lending money to Popes in the 1400s. People who lent money will lose some of it. Period.

• *Saving the banks*. We're told that Greece must be bailed out, or large banks will fail. Savor the outrageous irony of this claim. Apparently, two years after the great mortgage meltdown, Europe's army of bank regulators missed the fact that large, "systemically important" banks had made firm-threatening bets on Greek debt. So much for the idea that more regulation will keep complex banks out of trouble.

If the claim is true (which I doubt), the right answer is to save the specific "systemically important" banks (or, better, their "systemically important" activities), not to bail out every Greek bondholder and the Greek government and to paper over the vast bank and regulatory failure that set up the problem.

Greece got in to trouble when it tried to sell new debt to repay its maturing short-term debt, just as Bear Stearns and Lehman Brothers did. If Greece had sold long-term debt, there would be no sudden crisis. In all the talk of restructuring euro finances, nobody is talking about forcing governments to borrow long-term, nor of managing the crisis by forcing short-term debtholders to accept new long-term debt rather than cash.

Letting someone lose money on sovereign debt is the acid test for the euro. If not now, when? It won't happen in good times, nor to a smaller country. The sooner the EU commits, and other countries and their lenders come to terms with the fact that they will not be bailed out, the better.

The current course—ever-larger and less-credible bailout promises, angry German voters who may vitiate those promises, vague additional fiscal supervision (i.e. more of what just failed miserably)—is not the answer.

The only way to solve the underlying euro-zone fiscal mess (and our own) is to slash government spending and to focus on growth. Countries only pay off debts by growing out of them. And no, growth does not come from spending, especially on generous pensions and padded government payrolls. Greece's spending over 50% of GDP did not result in robust growth and full coffers. At least the looming worldwide sovereign debt crisis is heaving "fiscal stimulus" on the ash heap of bad ideas.

Mr. Cochrane is a professor of finance at the University of Chicago Booth School of Business.