THE WALL STREET JOURNAL.
WSJ.com

OPINION | DECEMBER 2, 2010

'Contagion' and Other Euro Myths

Restructuring short-term debt as long-term debt—which is what default really means—would hardly be the end of the world.

By JOHN H. COCHRANE

Over the weekend, European finance ministers and the International Monetary Fund (IMF) announced a €90 billion fund to bail out Ireland. They also promised that no sovereign bondholder would lose a cent, at least through 2013. The amount of fuzzy thinking behind this decision is even bigger than the heap of euros now being shoveled upon Dublin.

The bailout is being justified on grounds of containing "contagion." This is nonsense. The notion is that news of an Irish restructuring would scare investors in Spanish bonds, who would start looking at Spain's ability to repay its debts and then demand higher interest rates.

But haven't investors in Spanish bonds already noticed that there's a bit of a problem? And wouldn't news of a giant bailout make these investors question Spanish finances as much as would news of debt restructuring?

Any contagion is entirely self-inflicted. The only way Ireland's fate affects Spanish investors is by changing the odds that the European Union (EU) will bail out Spain. And Spanish interest rates are rising, suggesting investors now think a Spanish bailout is less, not more, likely.

This is not, in fact, an Irish bailout. It's a bailout of the European (including British) banks that lent a lot of money to the Irish government and Irish banks. If European governments want to bail out their banks, let them do so directly and openly—not via the subterfuge of country bailouts. Then they should face the music: How is it that two years after the great financial crisis, European banks make so-called systemically dangerous sovereign bets, earn nice yields, and then get bailed out again and again?

Chad Crowe

European bank regulators should announce that sovereign debt is not risk-free, and that their banks need capital against sovereign loans, or they need to buy insurance (credit default swaps) against sovereign exposure. Will taking this step hurt bank profits? Well, yes. Sorry. That game, at taxpayer expense, is over.

At least the announcement of the bailout fund breathed the possibility that some debt-holders might have to take a haircut someday. But it will only be after 2013, and only then on a "case by case" basis.

The middle of the bailout road—where Europe now stands—is the worst place to be. An ironclad bailout guarantee can calm markets, if not taxpayers and currency holders. An ironclad no-bailout position works as well: Markets adjust, banks stop betting on sovereign debt, and regulators realize the risk and demand some capital or credit default swap coverage.

A vague, case-by-case threat is the worst combination. Assessing the value of bonds becomes a guess about the intentions of EU and IMF officials. The next crisis will be that much harder for the same officials, since so many big financial institutions will have bet on bailout and will be lobbying them hard.

The big culprit in all of this is short-term debt. There would be no crises if governments had issued long-term debt to match long-term plans to repay that debt. If investors become gloomy about long-term debt, bond prices go down temporarily—but that's it. A crisis happens when there is bad news and governments need to borrow new money to pay off old debts. Only in this way do guesses about a government's solvency many years in the future translate to a crisis today.

There are two lessons from this insight. First, given that the Europeans will not let governments default, they must insist on long-term financing of government debt. Debt and deficit limits will not be enough. Second, the way to handle a refinancing crisis is with a big forced swap of maturing short-term debt for long-term debt. This is what "default" or "restructuring" really means, and it is not the end of the world.

Governments like to roll over short-term debt for exactly the same reasons Bear Stearns and Lehman Brothers did: It looks cheaper—at least until the crisis comes. But buying insurance is always expensive.

It's far less expensive than bailing out everyone, which is impossible. The party has to end somewhere. If not with Ireland, then with Spain. If not with Spain, then with Italy. If not Italy, then Germany. If not with Germany, then with printed euros and inflation.

Deep misunderstandings of the euro aren't helping. A currency union does not require a debt union. The major danger to the euro right now is that the European Central Bank is buying weak sovereign debt—not that Ireland or Spain might restructure. The euro as a currency is stronger if it is insulated from sovereign default.

We in the U.S. shouldn't indulge in schadenfreude. Bad ideas lead to bad decisions, and we are not lacking the former. Many U.S. states remain in deep trouble, and the federal government is still in a long-term fiscal pickle.

Our governments have also guaranteed trillions of dollars of debt—everything from mortgages and student loans, to say nothing of implicit guarantees to banks and state and local governments. These guarantees don't show up anywhere on the books, but investors could start adding them up very quickly. Remember that Ireland got into trouble by guaranteeing bank debt. U.S. government debt is also remarkably tilted to short maturities, with the majority being rolled over every year. The Federal Reserve's quantitative easing will tilt us further to shorter debt.

If, say, states start threatening default, will we act with any more wisdom? Not if we swallow the blarney coming out of Europe.

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