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# Last Chance to Save the Euro

*A Greek default won't destroy Europe's currency. Bailouts will.*

By JOHN H. COCHRANE

The European debt discussions always paint the alternatives as either bail out countries (really, bail out their bondholders) or break up the euro. In fact, the euro and the European economic union would be stronger if countries can default. For that reason, I advocated letting Greece go a year and a half ago when the crisis first erupted.

That chance to save the euro is fading. The European Central Bank (ECB) has bought sovereign debt from Greece, Portugal, Ireland, Italy and Spain. It has lent even more money to banks whose main asset is the same sovereign debt. Deposits are fleeing those countries' banks, and lending from the ECB is making up the difference.

Bank regulation is making the situation worse: Banks carry most of the ECB and sovereign debt at face value. And their own governments are pressuring banks to buy more sovereign debt.

When the defaults come, the ECB will take a big hit. Then Germany and the others will be faced with an awful choice: Pony up trillions to "recapitalize" the central bank or abandon the euro along with the union it represents.

"Eurobonds" that would be issued to buy sovereign debt, backed by EU-wide taxes, have been suggested but aren't going anywhere in the face of taxpayer resistance. In reality, Eurobonds have already been issued—they are called euros. The countries of the European Union are already pledged to make up any capital loss of the European Central Bank, and this must eventually come from tax revenues. That's the same as paying off Eurobonds.

The central bank doves and their defenders deny this is a problem. They say the ECB got collateral from banks. They say it "sterilized" the bond purchases, by selling high quality bonds to buy poor ones, so the total supply of euros did not increase. They think that euros will stay outstanding forever so central-bank capital does not matter.

But the ECB's collateral is the same sovereign debt that upon default will bring down the banks. If collateral evaporates on the same day as the loan, it's not collateral. "Sterilizing" is a mirage, and central-bank capital matters. When the ECB needs to raise rates or contract the money supply, it needs assets to sell to soak up euros. And if currency holders know the central bank is empty, they will run away from euros, so that need to buy euros may come quickly.

The ECB involvement has only just begun. Last weekend's bright idea is to "leverage" the €440 billion bailout fund by borrowing from the ECB, and using the fund to insure debt rather than to buy it. In this way the fund could "support" trillions of euros of debt. But risk can only be transferred; it does not evaporate. And the risk ends up at the ECB and, ultimately, with taxpayers.

This sort of scheme should sound familiar from the financial crisis. Take a fund designed to buy bonds, and goose its credit exposure by leveraging and writing credit default swaps (bond insurance) instead. This move just explodes the ECB's already large lending against rotten collateral.

German Finance Minister Wolfgang Schauble saw through the scheme quickly, calling it a "stupid idea" that would "endanger the AAA sovereign debt rating" of other member states. I think he misspoke a bit. The goal is stupid, but it takes clever financial engineering to turn a €440 billion fund into several trillions of credit exposure.

And we can forecast more. What happens, say, when an Italian bond auction fails? The German taxpayer is unlikely to stand for direct government purchase, so the politicians will surely decide that the only immediate choice is for the ECB to provide what they will call "bridge financing."

Europe's deepest problem is bad ideas. Unpleasant price movements represent "illiquidity," "speculators," "market manipulation," "lack of confidence" and "contagion," not the hard reality of looming default. The point of policy is to "calm markets" and "provide confidence"—not to solve financial problems.

When the price of bread rose in their revolution, the French took bakers to the guillotine. They got more inflation, and less bread. When their descendants saw bond prices falling, they passed restrictions on short sales. They got lower prices, and less liquidity.

This is not a temporary market dislocation. This debt will not be paid back. Greece and the others might well rather default. Cleared of past debt, like Argentina, they are likely to be able to borrow again soon. These countries surely don't want austerity. And least of all do their political classes want to reform their great-scam states—there is pervasive rot in an economy where every occupational license is a political favor—though reform is the one thing that could actually return them to strong growth and let them pay back debt.

Facing global markets might be enough pressure for them to reform. Facing the International Monetary Fund and the ECB is surely not.

The euro, and the economic integration that goes with it, must be saved (political, regulatory, bureaucratic, and fiscal integration less so). Greece has 11 million people, about the same as the Los Angeles metro area, and a $320 billion gross domestic product, about the same as Maryland. It needs its own currency—and to rely on periodic devaluation of that currency for competitiveness—like a hole in the head. That road leads to trade and capital isolation.

The worst idea of all is that Europe's admirable economic free trade zone and currency union cannot survive a sovereign default. It is precisely allowing sovereign default, and isolating the central bank from sovereign default, that is the only way to keep the union together. That is, after all, how the euro was set up in the first place. It's almost too late. But not quite.

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