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How Bad Ideas Worsen Europe's Debt Meltdown: John H. Cochrane

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Europe is as full of bad ideas as it is of bad debts.

Conventional wisdom says that sovereign defaults mean the end of the euro: If Greece defaults it has to leave the single currency; German taxpayers have to bail out southern governments to save the union.

This is nonsense. U.S. states and local governments have defaulted on dollar debts, just as companies default. A currency is simply a unit of value, as meters are units of length. If the Greeks had skimped on the olive oil in a liter bottle, that wouldn't threaten the metric system.

Bailouts are the real threat to the euro. The European Central Bank has been buying Greek, Italian, Portuguese and Spanish debt. It has been lending money to banks that, in turn, buy the debt. There is strong pressure for the ECB to buy or guarantee more. When the debt finally defaults, either the rest of Europe will have to raise trillions of euros in fresh taxes to replenish the central bank, or the euro will inflate away.

Leaving the euro would also be a disaster for Greece, Italy and the others. Reverting to national currencies in a debt crisis means expropriating savings, commerce-destroying capital controls, spiraling inflation and growth-killing isolation. And getting out won't help these countries avoid default, because their debt promises euros, not drachmas or lira.

Perils of Devaluation

Defenders think that devaluing would fool workers into a bout of "competitiveness," as if people wouldn't realize they were being paid in Monopoly money. If devaluing the currency made countries competitive, Zimbabwe would be the richest country on Earth. No Chicago voter would want the governor of Illinois to be able to devalue his way out of his state's budget and economic troubles. Why do economists think Greek politicians are so much wiser?

The latest plan calls for Europe to be tougher in enforcing deficit rules that are similar to the ones that they blithely ignored for 10 years. Sure, a directive from Brussels is really going to get the Greeks to shape up. Imagine how well it would work if the International Monetary Fund or the United Nations tried to veto U.S. budget deficits. (That is, if our Congress passed budgets to begin with.) This plan is mostly a way to let the ECB save face and buy up bad debt with freshly printed euros.

More fiscal union hurts the euro. Think of Poland or Slovakia. Using euros was once a no-brainer: It made sense to use the same currency as all the other small countries around them, just as Illinois wants to use the same currency as Indiana.

Now, it's not so clear: If using this currency means signing up to bail out Greece and Italy, then maybe adopting the euro isn't such a good idea. A common currency without a fiscal union could have universal appeal. A currency union with a bailout-based fiscal union will remain a small affair.

Europeans leaders think their job is to stop "contagion," to "calm markets." They blame "speculation" for their troubles. They keep looking for the Big Announcement that will soothe markets into rolling over another few hundred billion euros of debt. Alas, the problem is reality, not psychology, and governments are poor psychologists. You just can't fill a trillion-euro hole with psychology.

President Nicolas Sarkozy of France said Greece is like Lehman Brothers Holdings Inc. and its collapse would bring down the financial system. Greece isn't Lehman. It doesn't have trillions of dollars of offsetting derivatives contracts. It isn't a broker-dealer, whose failure would freeze all sorts of assets. Its creditors don't have the legal right to seize assets owed to counterparties. Greece is just a plain-vanilla sovereign borrower, like those that have been defaulting since Edward III stiffed the Perruzzi bank in the 1340s.

Banks' Debt

Sovereign default would damage the financial system, however, for the simple reason that Europe has allowed its banks to load up on debt, kept on the books at face value, and treated as riskless and buffered by no capital.

Indebted governments have been pressuring banks to buy more debt, not less. As banks have been increasing capital, they have loaded up even more on "risk-free" sovereign debt, which they can use as collateral for ECB loans. The big ECB "liquidity operation" that took place yesterday will give banks hundreds of billions of euros to increase their sovereign bets. Bank depositors and creditors have figured this out, and are running for the exits.

By stuffing the banks with sovereign debt, European politicians and regulators are making the inevitable default much more financially dangerous. So much for the faith that regulation will keep banks safe.

The euro's fatal flaw then wasn't to unite areas with differing levels and types of development under one currency. After all, Mississippi and Manhattan use the same money. Nor was it to deprive governments of the ephemeral pleasures of devaluation. Nor was it to envision a currency union without fiscal union.

Banking misregulation was the euro's fatal flaw. Sovereign debt, which can always avoid explicit default when countries print money, doesn't remain risk-free in a currency union. Yet banking regulators and ECB rules continue to pretend otherwise.

So, by artful application of bad ideas, Europe has taken a plain-vanilla sovereign restructuring and turned it into a banking crisis, a currency crisis, a fiscal crisis, and now a political crisis.

When the era of wishful thinking ends, Europe will face a stark choice. It can have a monetary union without sovereign defaults. That option means fiscal union, accepting real German control of Greek and Italian (and maybe French) budgets. Nobody wants that, with good reason.

Or Europe can have a monetary union without fiscal union. That would work well, but it needs to be based on two central ideas: Sovereigns must be able to default just like companies, and banks, including the central bank, must treat sovereign debt just like company debt.

The final option is a breakup, probably after a crisis and inflation. The euro, like the meter, is a great idea. Throwing it away would be a real and needless tragedy.

(John H. Cochrane, a professor of finance at the University of Chicago Booth School of Business and an adjunct scholar of the Cato Institute, is a contributor to Business Class. The opinions expressed are his own.)

To contact the writer of this article: John H. Cochrane at john.cochrane@chicagobooth.edu.

To contact the editor responsible for this article: Max Berley at mberley@bloomberg.net.