CENTRE FOR EUROPEAN REFORM

The spectre of default stalks the eurozone

by Simon Tilford

A popular narrative has taken hold across much of the eurozone. The economic situation, so the story goes, is improving, or at least bottoming out, and the necessary institutional reforms are being put in place. True, progress is messy and imperfect given the politics, but the currency union is on the right track. This narrative, however, is complacent. The economic situation remains grim, not least because of a failure to strengthen the region's banks. And there is a disconnect between the scope of the reforms under discussion and the scale and immediacy of the crisis. This bodes ill for the solvency of Italy and Spain.

Europe, it seems, has become anaesthetised to bad news. Six consecutive quarters of economic contraction, record unemployment and rapidly rising debt burdens trigger little reaction from policy-makers. By contrast, an easing of the pace at which unemployment is rising, or tentative signs that there could be respite from outright recession, are cited as evidence of economic recovery. The reality, however, is that the Spanish and Italian economies will shrink by a further 2 per cent in 2013. Greece's is on course to contract by an additional 5-7 per cent and Portugal's by 3-4 per cent. Even Ireland will struggle to grow. The core's prospects are not much better. Germany is growing but the country's exports are faltering in the face of slump across the eurozone and a rapid slowdown in China, and it is far from clear that domestic demand will take up the slack.

The European Commission points to declining trade deficits across the eurozone periphery as evidence of improved competitiveness and hence of growth prospects. It is true that exports are growing (quite rapidly in Spain's case), but not by enough to offset the decline in domestic demand. Far from being on the mend, the economic crisis across the south is deepening. Real interest rates are increasing from already high levels, as inflation falls. Mounting bad debt is forcing banks to rein in lending, resulting in a wave of corporate insolvencies and more bad debt.

Eurozone policy-makers should be concentrating on bringing down borrowing costs. If 'competitiveness' is to mean anything other than a zero-sum game (in which countries compete to beggar their neighbours by cutting wages), it has to mean improved productivity. But Spain and

Italy will struggle to raise productivity relative to Germany if their businesses (and governments) have to pay three times as much to borrow as their German counterparts. For example, if businesses in the struggling German state of Saarland faced borrowing costs three times those of booming Bavaria, Saarland would remain depressed indefinitely, and dependent on transfers from stronger parts of Germany.

Spain and Italy cannot rely on transfers from the rest of the eurozone, but face a rapid worsening of their debt burdens as nominal GDP (growth plus inflation) falls. This so-called denominator effect – where declining GDP increases a country's debt burden as businesses, households and governments have less income with which to pay back debt – receives too little attention. Over the last year, Portugal's and Spain's debts rose by 15 percentage points of GDP, and Ireland's and Greece's by 18 and 24 points respectively. In Italy, which ran a budget deficit of just under 3 per cent of GDP in 2012, the ratio of debt to GDP rose by 7 percentage points (to over 130 per cent).

Even if Italy's nominal GDP is flat over the next year, the Italian government will have to run a primary budget surplus (a surplus before the payment of interest) of 5 per cent of GDP just to stabilise the public debt ratio. It is certainly trying – Italy's primary surplus is currently around 2.5 per cent of GDP – but the result has been a deep recession and a compounding of the denominator effect. The picture is even worse in Portugal and Greece, and not that much better in Spain.

Nominal GDP across the eurozone periphery needs to recover rapidly if these countries are to remain solvent. The reforms of eurozone governance in the pipeline are insufficient to ensure this happens. Although the terms of the banking union are still under negotiation, it is pretty clear that whatever is finally agreed will not break (or even significantly dilute) the link between banks and governments, because it will not include joint liability for eurozone banks. Unless there are big shifts in the bargaining positions of the various governments, the new supervisory body will have a big say over which banks should be closed down or bailed-out, but the money to do this will still be largely national. Only after creditors and depositors have been 'bailed in' and national governments have paid their share will 'federal' money be available, and then the amount is unlikely to be enough to act as a credible fiscal backstop. The mooted figure of €60 billion sounds large, but outstanding bank credit across the eurozone stands at €16.5 trillion. Only a tiny proportion of this would need to go bad to overwhelm the bail-out fund.

The prospect of the eurozone establishing a central budget able to provide effective counter-cyclical financing to hard-hit governments is also remote. A Franco-German paper issued in May proposed the establishment of a fund to provide limited and conditional financial support to struggling member-states, so long as they abide by a long list of policy prescriptions – from reforms of labour market and retirement systems to measures to boost public sector efficiency. Such a fund could theoretically form the embryo of a more substantive budget, but as currently proposed would do little to solve the problem.

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By activating the Outright Monetary Transactions (OMT) or a wider programme of quantitative easing, the ECB could bring down Italian and Spanish borrowing costs by enough to stabilise these countries' debt burdens. But the central bank might not be able to do either, not least because of opposition from a sceptical Bundesbank. If so, it is possible that Italy – home to the third biggest government debt market in the world – or Spain will at some point be unable to borrow enough money to meet their financing needs. The fact that Italy has limited foreign liabilities does not preclude this possibility. After all, Italian banks have to be willing and able to buy the debt the Italian government issues.

Sovereign defaults cannot be ruled out. The eurozone might be able to agree further loans to Portugal – which is losing its battle to comply with its existing bail-out programme – but the sums needed to bail-out Spain or Italy or both could overwhelm the European Stability Mechanism (ESM). Unless the ECB then stepped in to act as a fully-committed lender-of-last-resort to these countries' governments, or the ESM was expanded to become, de facto, a common borrowing instrument, default would become inevitable. At this point Spain and Italy would have to quit the euro, renege on their debts, and print the money needed to keep their banks afloat. The German election could well open the way for the more radical policies needed to prevent the crisis reaching this point. But as things stand, the current optimism looks misplaced.

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