

OPINION

How the Euro Zone Can Restore Confidence

By David Malpass

The world is waiting anxiously for Europe to use a bazooka on its debt problems—i.e., to make such a strong financial commitment to European banks and bonds that they become investable again, unfreezing markets.

But Europe probably won't go that far in this week's summits. This leaves in place a costly slow-motion bailout and a deepening recession.

Investors are looking for a home for trillions in idle Federal Reserve-generated dollars, and a little reform in Europe might attract them.

For the U.S., it means another drag on an economy already stalled by Washington's uncontrolled spending, taxes and regulation, as well as its weak-dollar policy.

The increasingly common view is that Europe's crisis will worsen and Europe will eventually have to either centralize its government (imagine Brussels booming like Washington) or let the euro break

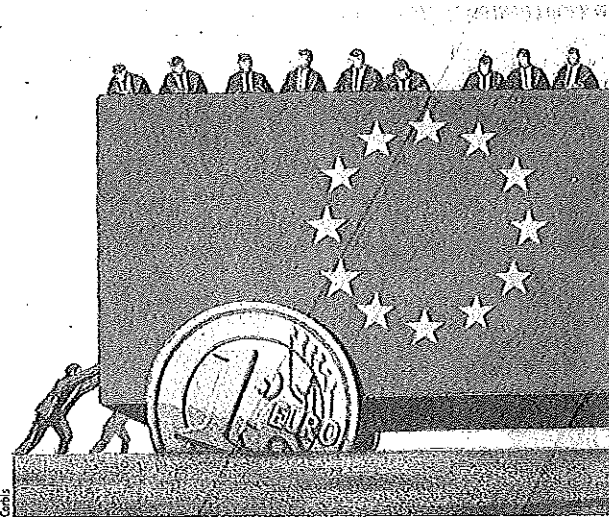
apart with some countries devaluing their way to much lower living standards.

Europe wants a healthier middle ground and so should the U.S. Europe's goal should be to control government spending, keep the euro zone together, and keep national finances separate in the interest of freedom and limited government. The problem is not the euro or national autonomy, but the euro-wide blindfold over a decade as national debts spiraled higher.

For now, Europe's borrowing costs outside Germany will probably keep rising as confidence declines, choking off investment and spreading Greece's crisis westward. Italy is already in a recession, and Monday's weak orders report from German purchasing managers confirmed the risk that even Germany may be sinking into recession.

This puts Europe's banking system at risk. It owns much of Europe's national debt and is therefore very sensitive to falling bond prices. As Greece and Portugal move toward restructuring their bonds, with banks taking a loss, key funding sources for European banks are drying up. These include U.S. money-market funds, Europe's floating-rate interbank market, and lately the large secured bond market.

The market's worry is that other heavily indebted countries will also



sink and restructure their bonds. For now, banks are selling assets and planning new equity issuance to fill the gap, and the European Central Bank (ECB) is temporarily providing unlimited loans to banks against weak collateral.

The bar for re-establishing confidence in Europe is probably not as high as it seems. A bold plan to cut

government spending and sell government assets would work. Investors are looking for a home for trillions in idle Federal Reserve-generated dollars, and Italy's 10-year bond has a yield of 6% compared to only 2.2% for the U.S. 10-year Treasury.

As growth deteriorates and governments refuse to downsize, Europe will be tempted to go all-in, using overwhelming financial force to restore confidence to Italian and Spanish bonds and stabilize bank funding. One technique is faster asset purchases by the ECB, enough to reduce bond yields in Italy and Spain.

This is the approach the Fed used in late 2008 when it announced that it would purchase over a trillion dollars in mortgage bonds. The severe downside was that the unbounded Fed purchases have opened a Pandora's box of taxpayer risk and market uncertainty that will last decades.

The Fed remains fascinated with continued large-scale asset purchases even after the 2008 systemic crisis is long over and consumer-price index (CPI) inflation has hit 3.9%. Germany is more protective of stable money and price stability than the U.S. and has rejected the option of the ECB making Fed-sized asset purchases.

During the 2008 crisis, the U.S. developed another overwhelming force that might stabilize Europe's

funding problem. Four weeks after Lehman Brothers filed for bankruptcy, the Federal Deposit Insurance Corp. said it had the jaw-dropping authority to guarantee apparently unlimited amounts of new unsecured bank debt. Before this program ended, major banks were issuing five-year debt with a 100% FDIC guarantee even though the FDIC insurance fund was itself rickety.

Contrast this with Europe's hesitation over even partial insurance for Europe's sovereign bonds.

Still missing, however, is proof that governments like Italy's (and America's) can restrain spending or sell government assets fast enough to pay down debt. Italy's debt-to-GDP ratio is already 120%, more than double a sustainable level, while the U.S., with a 70% ratio—\$10.5 trillion marketable debt not counting entitlements, versus \$15 trillion in GDP—is on course to grow the debt ratio to 85% by 2016 and 100% by 2021.

When economies and the work force were growing, politicians and government unions promised workers they would pay their pensions and health-care costs without limit. They counted on a pyramid of new workers and, at many U.S. pension funds, rosy assumptions about strong investment earnings and short life spans for retirees. They borrowed trillions, helped by low interest rates, faulty bond ratings, fake accounting and, in Europe, a political conspiracy to ignore the 3% European treaty limit on deficits.

Thus an epic battle is underway in Europe and the U.S. over the size of government amid shrinking resources. The euro zone's path forward is clear but politically difficult. As nations, they need to cut government spending, sell assets and allow private-sector competitiveness. As a part of a union, the euro zone has to divide up the losses from past deficits, restore confidence in sovereign bonds, and create a system that won't let politicians borrow as much as they did.

The alternatives—the current dilatory bailout or a faster path to default and the breakup of the euro—would be devastating for all.

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