

Eurozone Crisis – On the brink?

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Despite a welcome intervention by global central banks on 24/11, the Eurozone remains on a precipice as Brussels continues to hesitate in the face of German resistance. However, continued inaction is no longer viable; it is hoped that the coherent effort of the central banks will spur Europe to follow suit at the upcoming summit on the 9th of December to resolve the crisis.

Contagion spreads from Eurozone periphery to the core

A potential watershed moment was the disappointing German bund auction on 24/11, with only 3.6 of 6bn 10 yr bunds sold. It is possible that the yields on offer were simply too low to tempt investors (at 1.98%), but it arguably demonstrated the crisis is no longer confined to the periphery.

New governments, crisis persists

Merkel had hoped that new, respectable technocrat leaders for Greece and Italy would improve market perception, but investors continued to shun the respective bonds, pushing Italian 10 yr yields to above 7.8%. Spain's newly elected government, committed to reforms and

austerity, also failed to cap Spain's 10 yr yields.

Looming recession

The continuing malaise tightens interbank short term lending while, additionally, firms are pulling deposits from peripheral banks. The new capital ratio requirement imposed on European banks is also adding pressure to strengthen balance sheets through asset sell offs. As a result, the credit crunch, fiscal austerity and a collapse in business and consumer confidence is threatening the Eurozone with a deep recession with a fall in output of about 2%.

Discussed solutions

● **Eurobonds** – one unilateral bond for the Eurozone guaranteed by all Eurozone governments (would require EU treaty changes), carrying a fixed financing rate. This would share the debt burden across all member states. Germany and other northern countries oppose this idea as they can no longer enjoy low financing rates and will carry on more debt.

● **ECB as lender of last resort** – the ECB will be ready to lend money to a bank if market financing is unavailable (e.g. UK government with Northern Rock). However, the President of the

Bundesbank, amongst others, is strictly against this, as the ECB does not have the mandate to do this and it could compromise its independence.

● **Fiscal Pact** – Germany and France are in the process of negotiating a potentially groundbreaking fiscal pact that would make budget discipline legally binding and enforceable by European authorities. Officials long regarded this policy as economically necessary but politically untenable. As such, it is hoped that the ECB will take more forceful action towards the crisis given this legally binding, debt controlling measure, especially as it is supported by Germany.

Other opinions

● **Buffett** – the debt crisis has shown a 'major flaw' in the Eurozone system and it will take more than words to fix it. Europe will either have to integrate more closely or come to another arrangement.

● **Soros** – action should be taken quickly to save Europe and leaders must fundamentally change their approach to succeed. The EFSF should be used as a guarantor to banks which would in turn be able to buy high yielding government debt of troubled Eurozone members. This would be a 'trick' to circumvent the flaw that Europe has a

single currency without a lender of last resort.

Currently, a breakup of any form of the euro could have detrimental effects on the global economic recovery. The severity of the current crisis has been underestimated, as have the political complexities. Political leaders, in an attempt to force peripheral countries to adhere to fiscal austerity measures, capped the bailout out solutions to levels that are neither economically viable nor acceptable by market sentiment. The situation that started in Greece two years ago is now threatening the breakup of the Eurozone.

Targeted pursuits have been accomplished, with a switch of inefficient governments to technocratic administrations, tasked with implementing corrective measures.

Mere fiscal austerity measures without accommodative support will not suffice. We are in need of a bold move.NOW.

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Keep the IMF out of Europe

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BUENOS AIRES - A short-lived rumor recently suggested that the International Monetary Fund was putting together a €600 billion (\$803 billion) package for Italy to buy its new government about 18 months to implement the necessary adjustment program. Except for the magnitude of the package, this sounds no different from a standard IMF adjustment program – the kind that we are accustomed to seeing (and criticizing) in the developing world. But there is one crucial difference: Italy is part of a select club that does not need outside rescue funds.

So far, programs for the eurozone periphery have been spearheaded and largely financed by European governments, with the IMF contributing financially, but mainly acting as an external consultant – the third party that tells the client the nasty bits while everyone else in the room stares at their shoes.

By contrast, the attempt to crowd multilateral resources into Europe was made explicit by eurozone finance ministers' call in November for IMF resources to be boosted – preferably through debt-generating bilateral loans, – so that it could “cooperate more closely” with the European Financial Stability Facility. That means that the short-lived story of Italy's jumbo IMF package, which was to be funded largely by non-European money, can be regarded as a game changer: while Italy may never receive such a package, Europe, it seems, is determined to resolve its problems using other people's money.

There are at least three reasons why the IMF should resist this pressure, and abstain from increasing its (already extremely high) exposure to Europe.

First, and most obviously, Europe already has its own in-house lender of last resort. The European Central Bank can make available all the euros needed to backstop Italy's debt. And printing them would only offset, through mild inflation, the effects of the otherwise Draconian relative price



adjustment that is taking place under the corset of the common currency.

So it is puzzling that some observers have saluted the IMF's involvement as a virtuous effort by the international community to bring the listing European ship to port. Why should the IMF (or, for that matter, the international community) do for Europe what Europe can but does not want to do for Italy? Why should international money be mobilized to pay for European governance failures?

And if, as appears to be the case, Germany is playing a dangerous game of chicken with some of its eurozone partners, why should the cost be shifted to the IMF for the benefit of Europe's largest and most successful economy? Letting the ECB off the hook in this manner would simply validate for Europe as a whole the same moral hazard feared by German and other leaders who oppose ECB intervention.

The second reason to avoid IMF intervention in Europe is that lending to a potentially insolvent country has serious implications for the Fund. For starters, taking the IMF's preferred-creditor status at face value, an IMF loan would entail substituting its “non-defaultable” debt for “defaultable” debt with private bondholders, because the Fund's money is used primarily to service outstanding bonds. As a result, a group of lucky bondholders would be bailed out at the expense of those that became junior to IMF debt and remained highly exposed to a likely restructuring. Since a “haircut” can be imposed only on whatever is left of the defaultable private debt, the larger the IMF share, the deeper the haircut needed to restore sustainability.

For the same reason, IMF loans can be a burdensome legacy from a market perspective. Because they represent a massive senior claim, they may discourage new private lending for many years to come.

This brings us to the third reason why the IMF should stay out of Europe's crisis: what if Fund seniority fails? The implicit preferred-creditor status is based on central-bank practices that establish that the lender of last resort is the “last in and first out.” It is this seniority that enables the IMF to limit the risk of default so that it can lend to countries at reasonable

interest rates when nobody else will. This works when the IMF's share of a country's debt is small, and the country has sufficient resources to service it.

But seniority is not written in stone: poor economies that are unable to repay even the IMF are eligible for debt reduction under the Heavily Indebted Poor Countries program, and 35 have received it since the program was established in 1996. What would happen if, in five years, Italy were heavily indebted to the IMF? What if private debt represented a share so small that no haircut would restore sustainability, forcing multilateral lenders to pitch in with some debt relief?

The IMF's seniority is an unwritten principle, sustained in a delicate equilibrium, and high-volume lending is testing the limit. From this perspective, the proposal to use the IMF as a conduit for ECB resources (thereby circumventing restrictions imposed by European Union's treaties), while providing the ECB with preferred-creditor status, would exacerbate the Fund's exposure to risky borrowers. This arrangement could be seen as an unwarranted abuse of Fund seniority that, in addition, unfairly frees the ECB from the need to impose its own conditionality on one of its members.

It makes little sense for the international community to assume that unnecessary risk. Let us hope that the IMF's non-European stakeholders will be able to contain the pressure. The solution for Europe is not IMF money, but its own.

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Is Modern Capitalism Sustainable?

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CAMBRIDGE – I am often asked if the recent global financial crisis marks the beginning of the end of modern capitalism. It is a curious question, because it seems to presume that there is a viable replacement waiting in the wings. The truth of the matter is that, for now at least, the only serious alternatives to today's dominant Anglo-American paradigm are other forms of capitalism.

Continental European capitalism, which combines generous health and social benefits with reasonable working hours, long vacation periods, early retirement, and relatively equal income distributions, would seem to have everything to recommend it – except sustainability. China's Darwinian capitalism, with its fierce competition among export firms, a weak social-safety net, and widespread government intervention, is widely touted as the inevitable heir to Western capitalism, if only because of China's huge size and consistent outsize growth rate. Yet China's economic system is continually evolving.

Indeed, it is far from clear how far China's political, economic, and financial structures will continue to transform themselves, and whether China will eventually morph into capitalism's new exemplar. In any case, China is still encumbered by the usual social, economic, and financial vulnerabilities of a rapidly growing lower-income country.

Perhaps the real point is that, in the broad sweep of history, all current forms of capitalism are ultimately transitional. Modern-day capitalism has had an extraordinary run since the start of the Industrial Revolution two centuries ago, lifting billions of ordinary people out of abject poverty. Marxism and heavy-handed socialism have disastrous records by comparison. But, as industrialization and technological progress spread to Asia (and now to Africa), someday the struggle for subsistence will no longer be a primary imperative, and contemporary capitalism's numerous flaws may loom larger.

First, even the leading capitalist economies have failed to price public goods such as clean air and water effectively. The failure of efforts to conclude a new global climate-change agreement is symptomatic of the paralysis.

Second, along with great wealth, capitalism has produced extraordinary levels of inequality. The growing gap is partly a simple byproduct of innovation and entrepreneurship. People do not complain about Steve Jobs's success; his contributions are obvious. But this is not always the case: great wealth enables groups and individuals to buy political power and influence, which in turn helps to generate even more wealth. Only a few countries – Sweden, for example – have been able to curtail this vicious circle without causing growth to collapse.

A third problem is the provision and distribution of medical care, a market that fails to satisfy several of the basic requirements necessary for the price mechanism to produce economic efficiency, beginning with the dif-

iculty that consumers have in assessing the quality of their treatment.

The problem will only get worse: health-care costs as a proportion of income are sure to rise as societies get richer and older, possibly exceeding 30% of GDP within a few decades. In health care, perhaps more than in any other market, many countries are struggling with the moral dilemma of how to maintain incentives to produce and consume efficiently without producing unacceptably large disparities in access to care.

It is ironic that modern capitalist societies engage in public campaigns to urge individuals to be more attentive to their health, while fostering an economic ecosystem that seduces many consumers into an extremely unhealthy diet. According to the United States Centers for Disease Control, 34% of Americans are obese. Clearly, conventionally measured economic growth – which implies higher consumption – cannot be an end in itself.

Fourth, today's capitalist systems vastly undervalue the welfare of unborn generations. For most of the era since the Industrial Revolution, this has not mattered, as the continuing boon of technological advance has trumped short-sighted policies. By and large, each generation has found itself significantly better off than the last. But, with the world's population surging above seven billion, and harbingers of resource constraints becoming ever more apparent, there is no guarantee that this trajectory can be maintained.

Financial crises are of course a fifth problem, perhaps the one that has provoked the most soul-searching

of late. In the world of finance, continual technological innovation has not conspicuously reduced risks, and might well have magnified them.

In principle, none of capitalism's problems is insurmountable, and economists have offered a variety of market-based solutions. A high global price for carbon would induce firms and individuals to internalize the cost of their polluting activities. Tax systems can be designed to provide a greater measure of redistribution of income without necessarily involving crippling distortions, by minimizing non-transparent tax expenditures and keeping marginal rates low. Effective pricing of health care, including the pricing of waiting times, could encourage a better balance between equality and efficiency. Financial systems could be better regulated, with stricter attention to excessive accumulations of debt. Will capitalism be a victim of its own success in producing massive wealth? For now, as fashionable as the topic of capitalism's demise might be, the possibility seems remote. Nevertheless, as pollution, financial instability, health problems, and inequality continue to grow, and as political systems remain paralyzed, capitalism's future might not seem so secure in a few decades as it seems now.

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