

Robert Genetski

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## EUROPE'S SOLUTION

### **European Solution Opts for Bureaucracy in lieu of Market Discipline**

There is a much to approve of in today's statement issued by the Euro leaders. From a positive perspective, the leaders succumbed to market pressures by accepting a more realistic value for Greece's debt. One of the major problems to this point had been a failure to recognize the loss of value on Greek bonds and the implications for bondholders, including French banks. Just this past summer, European bank stress tests had assumed face value for all sovereign debt.

The failure of US money market funds to renew deposits with European banks created the potential for a liquidity crisis. Fortunately, quick action by the European Central Bank, in cooperation with the Federal Reserve, restored the shortfall in dollar deposits and avoided a liquidity squeeze. Three years ago, perverse action by US regulators promoted such a squeeze leading to the meltdown in the US financial system.

### **The Good News**

In addition to avoiding a liquidity squeeze and valuing Greek debt closer to market value, Europe's leaders also agreed to some potentially healthy longer-term reforms. These include encouraging member countries to establish balanced budgets, preferably thorough constitutional amendments such as those now being considered in the US.

The leaders also received commitments for controlling pensions and other government spending and well as for reducing labor market rigidities. There is widespread recognition that without stronger growth Europe's problems will continue and that expansive government spending and restraints in labor markets contribute to poor economic performance.

### **The Bad News**

While the immediate effect of this agreement should enable Europe to dodge the bullet associated with recent market turmoil, the agreement also creates the seeds for future problems. The most significant problem stems from Europe's overriding desire to pursue bureaucratic solutions while ignoring market signals. This will provide a major drag on future European growth.

Ideally, financial markets should dictate the value of each nation's debt. In this way market discipline promotes fiscal discipline. When individual nations pursue fiscally irresponsible

policies, the value of their debt should decline. This forces those nations to pay progressively higher interest rates. Market discipline effectively punishes fiscally irresponsible nations and rewards those with the more responsible policies. Banks purchasing bonds from weaker countries run the same risk of losing money as they would with any other loan. As the value of their bonds fall, banks would be forced to increase their capital positions to offset the losses.

European leaders have chosen to downplay the discipline associated with market pressures. Instead, they have chosen a highly bureaucratic vision of the Eurozone. They insist that (except for Greece) all sovereign debt is and will be worth face value. To insure this value the zone will review each nation's budget and insist on other policy changes to assure they comply with a consensus assessment of fiscal responsibility. Furthermore, bureaucratic dictates will help determine measures to promote growth and allow for financing decisions related to assisting nations with debt problems.

The "solution" chosen by Eurozone leaders goes to the heart of Europe's problems. As governments have taken on more power and responsibility, economic growth has withered. Europe's leaders have now agreed to place even more power in the hands of Europe's collective decision making process in hopes that edicts can effectively replace markets at disciplining wayward nations.

Often lost in bureaucratic decisions are the negative implications of various decisions. Efforts to provide for emergency funds to promote stability shift precious resources from businesses to bureaucrats. This weakens the private sector. Also, arbitrary edicts to raise bank capital in lieu of basing such requirements on the market value of bank assets can have similarly adverse consequences.

While its leaders may have avoided an immediate threat to financial stability, their decisions are unlikely to advance the type of strong growth consistent with a long-term solution to Europe's problems. Instead, they are likely to produce an extended period of economic stagnation for the European nations.