Eurozone crisis is a buyers' strike

Commentators portray the markets as aggressively attacking European government bonds. **David Rowe** *argues what is really happening is a buyers' strike motivated by fear – and warns failure to recognise this could result in bad policy*

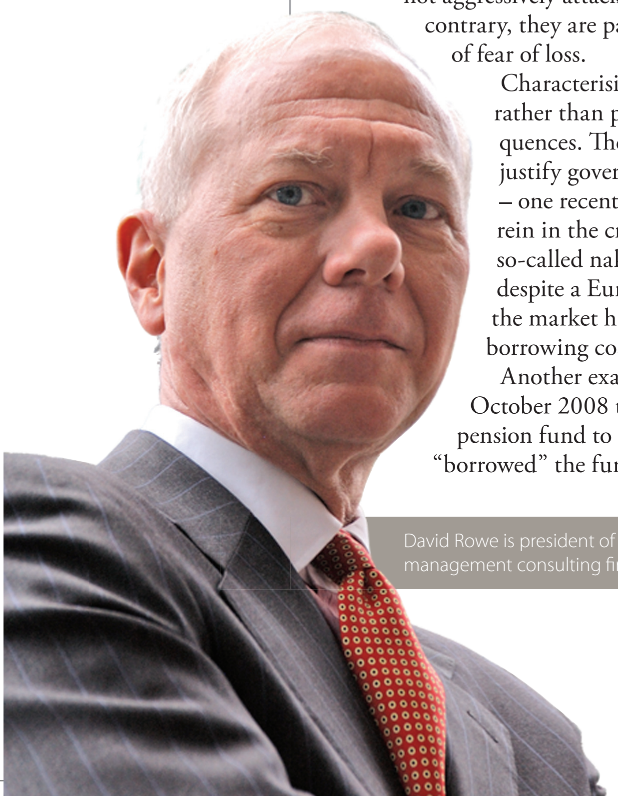
A common human failing is the tendency to allow muddled language to undermine clarity of thought. One example are the euphemisms used to avoid confronting harsh realities. Thus 'crippled' becomes 'handicapped', which becomes 'differently abled'; violent terrorists become insurgents and a Greek default becomes a voluntary restructuring.

Sometimes the transformation works in reverse, adding inappropriate colour and drama in a way that obscures reality. This tendency can be seen in coverage of market forces as they relate to the eurozone crisis, and is not confined to philosophical opponents of free markets. Looking no further than resources within my reach, a *Financial Times* editorial says "market psychology is such that Italy was always destined to be the next target". *The Economist* writes of the need for "a plan bold enough to stun the markets into submission". *The Wall Street Journal* pictures the market as a raging bull trying to gore a matador's cape rendered as a €10 note. In each case, the market is portrayed in a way that brings to mind barbarians at the gate or rebellious peasants wielding hammers and pitchforks.

Rather than an attack by aggressive market forces, the source of the euro crisis is more accurately characterised as a buyers' strike. Investors are, first and foremost, anxious to preserve their capital. When market participants lose confidence in an instrument's assurance of simple capital preservation, they naturally avoid expanding their holdings of it and divest existing holdings when feasible. Markets are not aggressively attacking a class of investments – on the contrary, they are passively withdrawing from them out of fear of loss.

Characterising markets as angry and aggressive rather than passive and fearful does have consequences. The distorted imagery can be used to justify government action to "tame the markets" – one recent example being Europe's attempts to rein in the credit default swap market by banning so-called naked trading of credit default swaps, despite a European Commission study concluding the market had little or no impact on sovereign borrowing costs.

Another example is the Argentine government's October 2008 takeover of the assets of a private pension fund to "protect its beneficiaries". It then "borrowed" the funds to cover operating expenses. In the US, the 2009 bail-out of General Motors played fast and loose with the rights of bondholders relative to other supposedly *pari passu* claimants such as union pension funds. This is worrying – the legal sanctity of private property rights is a cornerstone of modern industrial economies, but if current uncertainties evolve into a full-blown crisis, further incursions on private property rights "to deal with a crisis precipitated by aggressive markets" cannot be ruled out.



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The buyers' strike also highlights a fundamental flaw in the popular understanding of macroeconomic theory. Many speak as if deficit-funded fiscal spending is the obvious and logical policy to counter any recession – thinking that is rooted in the simple, hydraulic model of spending and income that dominated introductory economics texts for many years. That model had many shortcomings, the most serious of which was little or no role for bankruptcy of either private or public institutions – but large and prolonged fiscal stimulus necessarily leads to rising levels of government debt relative to GDP, a process that eventually becomes unsustainable, as Greece demonstrates.

The US is not likely to face the same kind of crisis as Greece because its debt is denominated in its own currency. It is always possible for the US government to create the dollars to pay off its debt. This would, however, put pressure on the value of the dollar in terms of both purchasing power (through inflation) and on the relative value of the dollar versus other currencies (through exchange rate devaluation). What could easily happen to the US is that debt holders start demanding higher interest rates to roll over maturing issues. Given that rates are at historic lows, it is very easy to see them rising to four times current levels, or even higher. This would further aggravate the need for additional debt just to pay the dramatically higher interest cost.

Ultimately, only time will allow us to correct the excessive debt and unfunded public and private pension obligations that have built up during the post-World War II period. Unrestrained deficit-funded public spending raises the spectre of a still larger, and ultimately unsustainable, level of debt that could trigger an even worse crisis. We already see the outline of this in Spain, where the ability of the government to bail out its own banks is in serious doubt.

Major regulatory reform combined with radical tax simplification and increased assurance of a stable environment for business innovation would do a great deal to promote recovery without risking creation of unsustainable government debt. As pointed out in last month's column, limiting the size of banks and revising bankruptcy laws to eliminate the too-big-to-fail concept would be a good start (*Risk* June 2012, page 66, *www.risk.net/2175496*). ■