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# Do not fall for talk of European solvency

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While the Europeans are celebrating the end of the financial crisis, something strange is happening in the bond markets. The gap in the yields – the spread – between the 10-year bonds of peripheral eurozone countries and Germany has been growing at an alarming rate. It is now close to the level that prevailed in the days before the European Union decided to set up its bail-out fund in May.

Last Friday, the spreads were 3.4 per cent for Ireland, 9.4 per cent for Greece, 3.4 per cent for Portugal, and 1.7 per cent for Spain. The yield on 10-year German bonds is currently ridiculously low, about 2.3 per cent. The financial markets somehow regard Germany as a paragon of virtue, stability and sound financial management, and are happy to demand virtually no return on 10-year investments. If the bond markets were ever returned to normal, and if the spreads were to persist, peripheral Europe would find itself subject to an intolerable market interest rate burden.

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18

This observation gives rise to the immediate question of whether some countries would be able to remain solvent under such a scenario. Solvency is defined as the ability to finance debt in a sustainable way, and is affected both by the amount of debt, and future income through which the debt is repaid.

Spain is probably fine for the time being. Portugal's combined private and public sector debt adds to well over 200 per cent of gross domestic product. In Ireland, the main problem is the banking sector. The economists Peter Boone and Simon Johnson have done some of the maths and found that the total amount of debt likely to end up with the Irish government amounts to about one-third of GDP. They concluded that with 10-year market rates at current l[illegible] – close to 6 per cent – Ireland is effectively insolvent. To correct this Ireland would need t[illegible]nerate spectacular rates of future growth. But do we really believe that the Celtic Tiger trick can be replicated? Was the presence of a global financial bubble not inherent in that model?

In Greece, the adjustment programme is going well – much better than anyone had hoped. Some of the people directly involved with whom I have spoken are almost euphoric in their praise for the Greek government's approach to the crisis. I also take the government's commitments seriously, certainly as regards fiscal adjustment.

I am less optimistic when it comes to structural reforms. But we should remember that even if you make a moderately optimistic assessment about policy changes in Greece, solvency is far from assured. I have yet to see a realistic estimate of a trajectory that foresees a stabilisation of the Greek debt-to-GDP ratio at a tolerable level. Instead, the optimists tend to pull the joker of some massive above-average growth forecasts for the future without explicitly stating where this growth is coming from.

The business confidence indicators that we have all been admiring in recent weeks tell us that the global economy has recovered from the depth of a near-depression in 2009, but they tell us nothing about the nature and the sustainability of the recovery. To guarantee the solvency of the eurozone's periphery would require not a few quarters of solid growth, but an entire decade. I am at a loss to understand how countries still recovering from an enormous asset implosion can generate so much growth.

We can either dig our head in the sand or prepare for the inevitable – that one day a eurozone state will either default, or, more likely, be forced to restructure its debt. It is important not merely to accept the principle, but also to make the institutional preparations for an orderly default of a eurozone member. It is going to happen.

There is a further factor we must take into account in our calculations about solvency. The optimists' scenario assumes that the various asset price bubbles have already fully self-corrected. That may not be the case, as we are currently seeing in the US, where the housing

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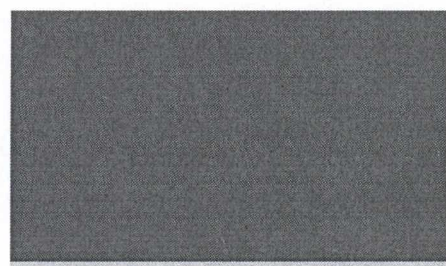

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market is going into a double dip. In times like these, volume and inventory statistics give us a more accurate picture of underlying market conditions than prices.

In peripheral Europe, the reality is one of extremely low turnover, and massive unsold stocks. The situation may be a little different in the UK housing market, which along with Hong Kong must be one of the most pathological in the world. But in most countries, real house prices do not change much over very long periods. In the US they have been almost stable for the last 100 years; in Germany they have not grown since the 1950s. If you assume a flat long-term trajectory of real house prices in Europe's periphery, you must conclude that most of the price falls have yet to occur.

So when we assess the long-term path of the Greek adjustment programme, the fate of the Irish economy, or of peripheral Europe in general, we have to take into account some of the potential toxic dynamism of relatively high market interest rates, and further declines in asset prices. Yes, it is possible that Greece will get through this crisis, and repay all of its debt. But it is far more likely that parts of peripheral Europe will end up only repaying parts of their debt. That is what the bond spreads are telling us, and I think that the bond markets have got this one right.

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