

A Partial Solution To The Euro Crisis

A sovereign issuer never has to default on debt denominated in its own currency. This is only true if the sovereign issuer has the ability to print money. The countries in the euro are unique in that they are not able to unilaterally print euros. Only the ECB can do that.

Most of the immediate problems faced by Italy for example, stem from a failure of confidence. Italy runs a primary surplus. External debt is relatively low, comparable to the UK or the US. The solvency of a country is based very much on its refinancing cost.

If the ECB was willing to purchase an unlimited amount of Italian debt, chances are it wouldn't have to purchase a lot. And there are ways to limit the scope of those purchases and still draw a limit to Italy's borrowing costs.

The ECB could buy only Italian debt held by non-Italian residents. This would be restructured into longer dated debt buying Italy more time. The new debt should have cash trapping features commonly used in emerging market private lending. It might even result in a profit for the ECB. Domestic debt holders might present a problem since they might indirectly sell into the market. The ECB purchases therefore have to be bilateral off market trades. This mechanism is preferable to the ECB purchasing new issues since it quite rightly imposes some injury on the current holders of the debt.

It is a dismal state of affairs when most sovereign debt are now PIKs.

The above solution, indeed any solution is based on finding money. Europe has begged (China), borrowed (via the EFSF) and may be tempted to steal (through printing money.) So far there is no money in sight. The ECB may have no choice but to print. But here is why Europe is in a bind.

The ECB was built with Bundesbank DNA. Weimar Republic hyperinflation is still within the memory of the Germans.

Europe will cling to the Euro for all its flaws. Ironically, it is the Germans who

were excluded from the Treaty of Dunkirk just after the War who are desperately trying to hold it together for fear of a return to European disunity.