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Subject: Summers on Euro debt crisis

Good piece by Summers today on debt crisis, concurring that "the likely consequence of doing more upfront is lower cost in the long run.". Comes close to advocating Eurobonds. Worth a read:

What Europe Can Do To Restore Financial Stability (Summers, WP) Monday, July 18, 2011 Washington Post By Lawrence Summers

With last week's tumult in Italian markets, the European financial crisis has entered a new and far more dangerous phase, threatening both European monetary integration and the global recovery. Last week's drama surrounding bond auctions in Europe's third-leading economy should convince even the most hardened bureaucrat that the world can no longer let policy responses be shaped by dogma, bureaucratic agenda and expediency. It is to be hoped that European officials can engineer a decisive change in direction, but if not the world can no longer afford the deference that the International Monetary Fund and non-European Group of 20 officials have shown European policymakers the past 15 months.

Three realities must be recognized if there is to be a chance of success.

First, systemic confidence is essential in a financial crisis. Teaching investors a lesson is a wish, not a policy. U.S. policymakers were applauded for about 12 hours for their willingness to let Lehman Brothers go bankrupt. The shattering consequences that had on confidence are still being felt. The European Central Bank is right that punishing creditors for the sake of teaching lessons or building political support is reckless in a system that depends on confidence. Those who let Lehman go believed that because time had passed since the Bear Stearns bailout the market had learned and so was prepared. In fact, the main lessons learned had to do with how to best find the exits, and uncontrolled bankruptcies had systemic consequences that far exceeded their expectations.

Second, no country can be expected to generate huge primary surpluses for long periods for the benefit of foreign creditors. Meeting debt burdens at rates the official sector - let alone the private sector - is charging for credit would involve burdens on Greece, Ireland and Portugal comparable to the reparations' burdens that John Maynard Keynes warned about in "The Economic Consequences of the Peace."

Third, whether or not a country is solvent depends not just on its debt burdens and its commitment to strong domestic policies but also on the broader economic context. Liquidity problems left unattended become confidence problems. Debtors who are credibly highly solvent at interest rates close to or below their nominal growth rates become insolvent at higher interest rates, putting further pressure on rates, exacerbating solvency worries in a vicious cycle. This has happened in Greece, Portugal and Ireland; it is in danger of happening in Italy and Spain.

In short, the approach of the official sector lending more and more to countries that cannot access the market at premium rates of interest is unsustainable. The debts incurred will largely never be repaid even as their size discourages private capital flows and any growth-creating initiative. Assertions that the most indebted countries can service their debts in full at current interest rates only undermine policymakers' credibility when they assert that the fundamentals are relatively sound in Spain and Italy. Further lending at premium interest rates only increases the scale of the necessary restructuring. It is reasonable to argue that recognition of debt unsustainability in Greece has been excessively deferred. It is not reasonable to argue that Greek reprofiling or restructuring alone will address a growing general crisis in confidence.

A fundamental shift of tack is required toward an approach focused on avoiding systemic risk, restarting growth and restoring arithmetic credibility rather than simply staving off imminent disaster. Fortunately, the likely consequence of doing more upfront is lower cost in the long run. The precise details are less relevant than scope, but the crucial elements in any viable strategy include:

l European authorities must restate their commitment to solidarity as embodied in a common currency and the recognition that the failure of any European economy means the failure of the European economy and is unacceptable.

The most serious financial breakdowns - in Indonesia in 1997, Russia in 1998 and the United States in 2008 - come when authorities allow doubt about the basic functioning of the financial system.

l Interest rates for program countries must be reduced; there is no reason to charge a risk premium, which needlessly threatens the success of the whole enterprise, when failure is unacceptable.

l Countries whose borrowing rate exceeds a certain threshold should be exempted from contribution requirements for bailout funds. The last thing the marginal need is to be pulled down by the weaker.

l Countries judged to be pursuing sound policies should be permitted to buy E.U. guarantees on new debt issuances at a reasonable price payable on a deferred basis.

These measures would reduce payments for debtor nations and assure confidence in the stability of European banks.

The question of what is to be done with sovereign private debt remains. Creditors gain nothing from breakdown and have signaled that they will support an approach based on a menu of options. The key standard on which any approach - short- or long-term - should be judged is the genuine sustainability of program country debt repayments on realistic assumptions. Much of this will seem unrealistic given the terms of Europe's debate. But it seemed highly unrealistic even 10 days ago that Italy's solvency would come into substantial doubt. The alternative to forthright action today is much more expensive action - to much less benefit - in the not too distant future.

The writer, a professor and past president at Harvard, was Treasury secretary in the Clinton administration and economic adviser to President Obama from 2009 through 2010