Neither bail-outs nor Eurobonds will solve the debt crisis. We need to implement comprehensive reforms that will produce confidence and growth.

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Reforms, not bail-outs or Eurobonds, are the answer to the crisis engulfing not just the most vulnerable and indebted Eurozone countries but the single currency itself, warns **Leszek Balcerowicz***. And they offer both short and long-term solutions to the crisis.*

The Eurozone's fiscal problems are triggering memories of policies used to deal with similar crises in the past. In years past we have seen the IMF and comparable institutions acting as crisis lenders offering official bail-outs to distressed sovereign borrowers. We have witnessed the monetisation of public debt by central banks, and the outright reduction of this debt, either uni-laterally with defaults or through negotiation. Other crises have ended in fiscal consolidation or reforms.

The current debate on the Eurozone's fiscal problems is in my view excessively focused on official bail-outs, including the proposed massive purchases of government bonds by the European Central Bank (ECB), to the detriment of fiscal consolidation and reforms. We are reminded almost every day that either the bail-out efforts must be greatly expanded or the Euro will perish. The biased pressure being exerted reflects the advantages to be gained by certain parties, and the erroneous beliefs of others. As to the advantages to be gained, it is easy enough to understand why creditors should prefer bail-outs for the debtor countries. And many political leaders also welcome the way that official crisis lending can ease market pressures. The media, meanwhile, thrives on its role as bearer of bad news.

Then there are the mistaken beliefs that contribute to the bias towards bail-outs. The uninhibited use of metaphors like “contagion” or “domino effect” expresses the idea that, once disturbed financial markets become blind, violent and undiscriminating powers, so that once confidence in a given country is lost, all other governments are then in danger. On this basis, it must follow that only a formidable countervailing power like massive official intervention can break the presumed dynamics of the financial market. The widespread use of expressions like “a bazooka” or “it’s them or us” show just how prevalent is this manichean view of the behaviour of financial markets vis-à-vis the sovereigns.

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But the financial markets, even though disturbed, are not blind. They are capable of distinguishing, however imperfectly and belatedly, between the macroeconomic situations of various countries. That’s why we can see the widening spreads on government bonds between Germany and other Nordic countries and those of the “problem” governments in the Eurozone.

Another related fallacy is the assumption that reforms, although necessary, can bring benefits only in the longer run. Under this assumption, the short-term solutions (i.e. the reduction in the sharply increased yields an affected government has to pay) are reduced to bail-outs. Yet this is a misleading representation of the available policy options because properly structured reforms have both short-term and longer-term effects. One does not need, for example, to wait for the completion of a pension reform to see short-term benefits in the shape of reduced yields on government bonds. Markets react to the credible announcement of reforms and their implementation.

A brief look at the countries that have been especially affected by the financial crisis, and that suffered a huge increase in the yields on their government bonds in 2009, is very illuminating. One group – Bulgaria, Estonia, Latvia and Lithuania (the BELL group) – saw a surge in these yields in 2009, followed by a sharp decline. Another group – Portugal, Ireland, Italy, Greece and Spain (the PIIGS) – registered divergent developments: the yields on Greece’s and Portugal’s bonds have surged and so far have not declined, while those of Ireland have displayed, at least until recently, the downward dynamics.

These differences can be largely explained by the differences in the extent and structure of reforms in all these countries, because proper reforms can produce confidence and growth. Official crisis lending can at best buy time to prepare reforms, and can help to stop the banking sector crisis. But it cannot act as a substitute for reform. And all bail-outs can create moral hazard as they weaken the incentives for reforms that will avoid bad polices in the future. Official crisis lending to some extent replaces the pressure from financial markets with pressure from experts and politicians of creditor nations. It is not difficult to see that the latter form of pressure is likely to have some unpleasant consequences for European cohesion, both in creditor and debtor countries.

Among the proposed Eurozone bail-outs, none has come under the spotlight as much as the idea of massive purchases of problem countries’ bonds by the ECB. Three rhetorical devices are being used to press for this option:

- The concept of the “lender of last resort” is being stretched. It’s as though the central bank’s provision of liquidity to commercial banks was the same as its funding of governments;

- The alternative to this proposed option is starkly presented as “catastrophe”
- The policies of the US Federal Reserve System, the Bank of England and the Bank of Japan are referred to as though the mere reference to past examples is enough to prove the efficacy of ECB lending.

These rhetorical devices simply cannot be allowed to overshadow careful analysis of the various options. There has been surprisingly little comparative analysis of the effects of quantitative easing (QE) that involved massive purchases of government bonds in Japan, the U.S. and Britain. Yet what we know indicates that this operation is far from a free lunch because although potential benefits may appear in the short-run, costs and risks emerge later. In Japan, for example, QE could actually have contributed via very low interest rates to delays in reforms and the restructuring of the economy, thus weakening the longer-term economic growth and exacerbating fiscal distress. In the U.S., the slowdown during 2008-2011 was clearly not averted and QE has also contributed to the growth of asset bubbles in the world economy. As to Britain, economic growth is even slower but inflation much higher.

I believe that massive purchases of government bonds by the ECB would be an even worse kind of bail-out. It would exacerbate the problem of moral hazard as such purchases are potentially unlimited, and would also increase the risk of inflation along with other negative economic consequences. More generally, trust in the ECB as guardian of the Euro’s stability could be undermined, and the ECB would be granted a powerful new political position with politicians attempting to influence its purchase decisions. It would also further undermine the rule of law in the EU at a time when confidence in the way the treaties are respected is so crucial. The main solution to the Eurozone crisis lies in properly structured reforms in the affected countries. And experience clearly shows us that such reforms offer both a short-term and long-term solution.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics

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