Of Debts, Markets and 'Fiscal Cliffs' in Europe and the United States: Part I

William R. Cline says that the latest steps by the European Council improves prospects for Spain and Italy, potentially lifting prospects for them and the rest of Europe.

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Steve Weisman: The latest decisions in Europe have brought a measure of stability in the markets and some hopeful prognosis about the banking crisis. William Cline at the Peterson Institute for International Economics is here with me, Steve Weisman, to assess the situation, especially the question of whether markets have overreacted. Bill, has Europe turned a corner, and are markets reacting accordingly?

William Cline: I think they have turned a corner. They are addressing this vicious circle between the banks' solidity and the government's debt solidity by saying, "Look, the new support mechanism, the European Stability Mechanism, can lend directly to the banks, Spain in particular, something like €100 billion without that going on top of the Spanish public debt." So they're very clearly trying to address this part of the problem.

I think the broader picture is that Spain and Italy are really the core of the problem going forward. [They are] far larger economies, [with] far larger debt than any of the other countries that have gotten into trouble. And for both of those countries, I would argue that the real risk is a self-fulfilling prophecy whereby the markets basically attack the country and the interest rate goes up, then that makes it look like the debt's not sustainable because the interest rate is higher. The decisions last week effectively set the groundwork for short-circuiting that vicious circle. For saying, "Look, enough is enough, if the interest rate starts to go above say, seven percent, then there's going to be intervention to keep the markets from pushing it higher."

Steve Weisman: Intervention by whom?

William Cline: In the first instance, it would be the European Stability Mechanism. The communiqué said that the European Central Bank would coordinate with them and there are those who argue that the ECB, in fact, is going to have to bring firepower to this. One of things that was not really resolved is that the magnitude of the resources of the European Stability Mechanism is not really enormous enough to deal with the debt coming due in Spain and Italy over the next three years or so. That total amount of maturities coming due is on the order of more than a trillion euros. But I think part of the strategy here is to send a signal to the markets that they can't basically make a profit by starting a snowball that then determines its own destabilizing momentum.

Steve Weisman: Markets always seem to overreact. Why is that?

William Cline It is certainly true that for a number of years, you had no credit risk perceived in Europe. I had always interpreted that as simply that by going to a single currency, they had eliminated exchange rate risk, which had always been the cause of big differences between interest rates that countries like Italy and Germany had to pay before. But they had, in theory, created default risk.

I thought at the time, "Of course, that's purely academic because these are industrial countries; industrial countries don't default. They haven't defaulted since 1930s. No problem." Well, what we found out was that the shock of the Great Recession caused such huge deteriorations in their fiscal situations, they can get into trouble. Why do markets overreact? In some sense, the market is always trying to seek the price, but you can get bandwagon effects where it goes well beyond what the reasonable equilibrium is.

One of the mechanics of that is so-called "short covering," so that you can have a sudden improvement that may or may not last. One wonders how much will remain of the lower interest rates from the new package over the next several weeks and months and to what extent the declines we've seen so far are just mainly short covering. But certainly the US real estate market is ample evidence that markets can get it wrong because there again, the stylized fact was that real estate prices can never go down; if they get too high, they will simply stagnate for a number of years.

Steve Weisman You that Spain and Italy remain the core of the problem. If the markets are betting against Spain and Italy, can they survive?

William Cline: I think they can. But I think the authorities may be put to the test to come up with enough of a war chest to stave off the market barbarians at the gate, so to speak. You will recall that after the ECB put these two long-term refinancing operations on the table earlier over the past few months, there were two episodes of €500 billion euros each. The interest rates that Italy and Spain had to pay came down quite substantially.

I remember George Soros going on TV saying, "This looks like a pretty good bargain." So the question is at what point does the market again conclude, "Hey, this looks like a pretty good bargain. I can get almost nothing for US paper or I can get almost six percent for Spanish paper. And if I take the Spanish paper, what are the chances I'm going to have a default?" And I do think the decisions made last week reduced the risk of a default.

Steve Weisman: And the market's reflecting that?

William Cline: The Spanish spread of the German bonds went down by about 70 basis points. The Italian spread went down also by a lesser amount, but it still went down. But I maintain that as long as the interest rate is in the vicinity of six percent or less, both countries can easily make it through.

Steve Weisman: Even at seven percent [rates]?

William Cline: Absolutely. I mean, the calculation I did in this Policy Brief in February showed that if Italy makes its targets on the fiscal performance, even with seven and a half percent interest rates for the next several years, it could keep its debt from rising relative to its GDP. And it could even have some decline. Now, the fiscal performance is important, but Italy has shown that it can deliver on the fiscal side. It's been a bit of a puzzle to me why Spain has been so much in the crosshairs because their debt to GDP ratio is a lot lower than Italy's.

It's even lower than some of the other, like France. The main fear for Spain was that the banking sector would saddle them with a lot of debt like what happened in Ireland, so that suddenly they wouldn't have a lower debt ratio. I think most of the calculations that showed that even if that happened, it would be ten percent of GDP bumping up instead of forty percent of GDP bumping up as happened in Ireland. So I continue to think that both of them can make it and what they're getting is some reinforcement now that if the markets start really running an attack against them, there's going to be some support.

Steve Weisman: Bill, thanks very much. We're going to have another conversation about the fiscal cliff in the United States as a kind of part two to this. Thanks very much.

William Cline: Thank you, Steve.