Debt crisis

ECB seeks global support for euro zone fix

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Australia must use international forums to exert peer pressure on European politicians to act faster to avert a global downturn, one of the leaders of the European Central Bank has cautioned.

Lorenzo Bini Smaghi says Australia, through the G20, should push for faster action in Europe to implement the EFSF and cut deficits. **Photo: Bloomberg**

Warning of the “huge” risks of contagion from the euro zone debt crisis, ECB executive board member Lorenzo Bini Smaghi says the risks to the global economy are “on the downside” and that is dragging down business and consumer confidence and spreading European problems to Asian economies.

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Speaking to *The Australian Financial Review* , Bini Smaghi dismissed hopes that the global financial system could withstand a Greek debt default in the way it has survived others, saying that such a decision by an advanced economy would be a totally new event, with wider consequences for sovereign debt markets.

But he also expressed confidence that Greece could pay its way out of the crisis because it and other euro zone nations would make rational decisions to cut spending rather than face the “suicide” of default.

European woes continued to dictate trading in the local sharemarket yesterday. The ASX/S&P 200 Index closed down 39.3 points to 3863.9. Resource stocks were sold off as commodity prices dropped, including a big fall in the price of gold. The Australian dollar fell by US1.15¢ to US96.63¢ and is now at its lowest level in almost 10 months.

In early European trading, equity markets sold off and futures trading on Wall Street suggested the US market would fall overnight. The euro continued to depreciate and is now trading around a 10-year low against the yen.

Bini Smaghi’s comments came before a meeting of finance ministers at the weekend that agreed to do everything possible to avert an escalation of the debt crisis in Europe.

Press reports at the weekend said European financial ministers were set to establish a fund of up to €2 trillion ($2.8 trillion), managed by the new European Financial Stability Facility (EFSF) and the European Central Bank to provide insurance against the sovereign debt crisis spreading from Greece to Spain and Italy.

The International Monetary Fund annual meetings at the weekend ended without final consensus on a solution to the crisis.

Finance ministers want to bolster the amount of money available to help create a firewall around Greece, and to potentially bail out other European economies. But the sticking point, particularly in Germany, is reaching domestic agreement about providing the money.

“[Finance ministers] focused on their own internal restraints, so that we don’t have the outcome that we need,” said Antonio Borges, head of the IMF’s Europe department, according to the *Wall Street Journal* . While key players were acting in self-interest it was generating a “disastrous” collective result.

US Treasury Secretary Timothy Geithner warned at the weekend that failing to combat the turmoil could cause “cascading default, bank runs and catastrophic risk”.

In a rebuke to some European leaders, Bini Smaghi says that politicians are “looking after their own turf” when they should realise that their countries would suffer later if they failed to support pan-European action.

Objections are being raised in Germany, Finland, Slovakia, Slovenia and elsewhere to the EFSF, a €440 billion rescue fund that must be ratified by 17 parliaments before it can be implemented as planned by the end of the year.

“This is an example of the need to think more globally, among politicians and citizens. There is a discrepancy between the way people look at their own problems in their courtyard and the way the decision has an impact on a much bigger dimension," Bini Smaghi says.

Finance ministers and central bank governors from the Group of 20 nations promised last Friday to unveil a "bold action plan" but said it would be put in place at the Cannes summit of world leaders in the southern French city in early November. The deadline prompted market fears that the policy leaders were moving too slowly.

Australia could help confront this problem by using its membership of the G20 to urge faster action in Europe to reduce budget deficits and implement the EFSF, Bini Smaghi says. "These forums are there for dialogue but also peer pressure – and for making political leaders aware of their global responsibilities," Bini Smaghi says of Australia's role.

"Peer pressure is, I think, essential."

Bini Smaghi spoke to the *Financial Review* in his Frankfurt office last Wednesday, before heading to Washington DC for the International Monetary Fund meetings. The ECB's next comments on the crisis are expected today when it issues an assessment of monetary developments in the euro zone. Its next decision on interest rates will be on October 6.

He shares responsibility for running the ECB as one of six members of its executive board, while also voting on interest rate decisions with the governing council, including bank governors from the 17 euro-zone countries. Some say the wider group backs whatever decision is taken by the inner sanctum of six.

Sometimes called a fiscal hawk, Bini Smaghi received his PhD in economics from the University of Chicago in 1988 and last June saw off an attempt by Italian Prime Minister Silvio Berlusconi to remove him from his post, as ECB executive board members insisted that no national leader had the power to sack them. Asked if the present problems are as great as those encountered with the collapse of the Lehman Brothers investment bank, Bini Smaghi says: "Well, I hope we won't find out." He warned that a sovereign default could be worse than a bank failure.

"I think the problem is different in quality, in the sense that the default of a sovereign puts into question the quality of sovereign signatures, which is a totally new event and it would have an impact across the board among countries and the way in which financial markets work.

"Most of the cases of default have been in developing nations or emerging markets and it has mostly been on foreign debt, not domestic. So we haven't really experienced anything like what is happening right now."

Analysts from Commerzbank and other institutions have recently calculated that markets could withstand a Greek default, but Bini Smaghi rubbished that conclusion.

"Those who say this have no idea about how contagion works," he says.

"It doesn't take into account all the interconnections and what would happen in the financial system as a whole if something as fundamental as sovereign risk is put into question, sovereign signatures are put into question."

The ECB has done its own analysis of the possible scenarios in the near future with more troubling conclusions.

"Certainly we considered, and I think we have been confirmed in what we see, that contagion is huge," Bini Smaghi says.

"What we see in the last weeks confirms that. Second, the impact on the real economy, especially on the country itself, would be quite dramatic."

The ECB view is a sobering assessment for all euro-zone nations because it suggests that if they refuse to help Greece avoid a default they would pay a higher price later when the contagion spreads.

"As time goes by the contagion may cost the taxpayer even more," Bini Smaghi says.

"So this idea that there are easy ways to restructure public debt is really an invention of economists, who assume that certain things are easy just because they are too complicated for them to study."

Bini Smaghi insists, however, that a rational government would not choose such an option because it would amount of political suicide.

"You cannot exclude irrationality but you have to work on the assumption that ultimately people are rational and their elected politicians, too … Any politician who brings his country to a default would, I think, have a lot of difficulties to be re-elected. Take Argentina: the government was wiped out. It brings a country to such a social and even a humanitarian disaster that it would be very difficult to get re-elected."

While he warns of the risks of contagion, Bini Smaghi seeks to cool the alarm felt in Asian markets over the risk of a European collapse. He has said in recent speeches that countries such as Italy, Spain, Portugal, Ireland and Greece have the fundamentals to ride out the concerns over debt.

“It’s understandable that, seen from outside, people have difficulty understanding what’s happening,” he says of the way Australian and Asian markets see events in Europe.

“If you look at the fiscal fundamentals of Europe, they are much better than many other parts of the world. Look at the primary surpluses, for instance. If you compare the US and Japan and the euro area, there are several countries which are either in primary surplus or reaching primary surplus.”

With the exception of Greece, he says, euro-zone countries will stabilise their debt to gross domestic product in 2012 or 2013 and are already progressing with budget cuts.

The Australian Financial Review

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