Investors in Europe apparently think that the new year is a good time to put the past behind them. They had their investment meetings and decided that in 2014 it is worth earning the extra interest they can get by holding periphery debt – is this a structural change or simply a cyclical shift? As spreads on periphery debt fall, the paradox of risk habituation returns: investors become habituated to the risks of the Eurozone and stop worrying about it, taking the pressure off politicians, so no progress is made on the necessary reforms. But progress is most definitely still needed.

Spreads of Italian and Spanish bonds over German bunds are now back near early 2011 levels. Investors have decided that it is worth earning the extra interest they can get by holding periphery debt (Greece, Ireland, Spain, Portugal, Italy). Nothing else has changed: between December and January there was no progress on structural reforms; no big pronouncements from the European Central Bank; no big change in the economic data.

Spreads of Italian and Spanish bonds over German bunds are now back to levels not far from where they were in early 2011, just before the Greek Private Sector Involvement (default) was announced. Is this a structural change with investors finally deciding that the risks of a Eurozone breakup are nothing to worry about, or is it simply a cyclical shift due to better global growth prospects? For the sake of the Eurozone, it may be better if the sentiment is cyclical.

A cyclical factor could be that fixed income investors are worried about rising interest rates in the core European countries. Although there has been some divergence, yields on core bonds are still very correlated with US Treasuries, and most investors expect US Treasuries yields to rise. Rising yields mean lower bond prices and lower or even negative returns. Rising US yields may push up yields in the Eurozone core and periphery, but at least the higher interest rate in the periphery provides more offset.

Much of the peripheral debt in recent months has been bought by the domestic banks of those countries. For the banks it seems like a pretty obvious trade: with non-performing loans at historical highs, their troubled governments are viewed as not as risky as firms and households (the governments are more likely to be bailed out), and if their government defaults the banks have bigger things to worry about. So the banks earn the high interest rates and hope to make more money if the spreads tighten (as happened over the last year). Arguably these banks are behaving like the Japanese “zombie banks” of the 1990s: lending to government instead of lending to households for spending or firms for investment so that the economy can grow.

As spreads on periphery debt fall, the paradox of risk habituation returns (see Economist Insights, 14 January 2013). As investors become habituated to, or used to, the risks of the Eurozone but nothing goes disastrously wrong (except for Greece), they stop worrying about it. This takes the pressure off politicians, so no progress is made on the necessary reforms. Hence why it may be better if investor faith in the periphery is cyclical: the complacency risks building up the next leg of the crisis because no progress is being made. And progress is most definitely still needed.
More to do

Plenty of people may wonder if the Eurozone crisis is over: the economy is growing again; borrowing costs are low; fiscal austerity has been put in place; and economic imbalances are correcting. If they talk to an economist, that economist may well agree that the worst of the crisis has been resolved, but (as always with economists) he or she will point out that on the other hand it would be premature to say that the crisis is over. The first stage of the crisis was about stabilizing the debt trajectory and that has been achieved, but the second stage where debt needs to fall is still to come. Handling the impact on the economy will be a severe challenge.

Many countries still look fiscally unsustainable. Just as when someone goes to a bank to apply for a loan, the lender needs to consider whether the burden of the loan repayments is too big relative to their income. But even a highly indebted person’s debt may be sustainable if their income is growing quickly. For example, if the interest payments on someone’s debt costs them 5% of their income every year, but their income is growing at 6% every year, their income is outrunning their debt. The same is true for countries. If their interest payments relative to GDP are lower than the growth of nominal GDP (the tax base), then the country is outrunning its debt (if debt is steady).

It is not too surprising that the periphery countries are the ones whose interest payments exceed their trend (or potential) nominal GDP growth (chart 2). The countries in the blue shaded area of the chart have the potential to outrun their debt burden. The countries in the red shaded area, on the other hand, will be forced to borrow in order to meet their interest payments – which quickly becomes a vicious spiral as interest will need to be paid on this new debt. To avoid that, these countries must run a primary surplus (higher revenue than expenditure excluding interest payments) that is at least large enough to pay for the interest that they cannot outgrow.

There are four ways for a country to move from the red area to the blue area. The first and in principle best way would be to move horizontally to the right by increasing their potential growth rate. If only it were that simple – any country that knew how to do that would have done it by now. Well, actually most countries know that they can eventually achieve this through structural reform but are unwilling to do it.

The fourth way is to cheat: default on your debt and the interest payments go away. This is not costless – once you have defaulted you will have to continue to run a primary surplus because it will be a long time before anyone is willing to lend you any money.

Assuming that there is no default, relying on just one of the first three options is unlikely to be successful. Growth reforms take time, austerity is painful, and some interest will have to be paid. A combination of all three is likely to be most successful, but it will still take time. Most of the periphery has paused in both growth reforms and austerity. In those circumstances, are investors really wise to lend to them so cheaply?

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