

Excerpts of Dr. G's weekly report to clients:

As interest rates on European sovereign debt continue to soar, pressure is building on Germany to help bail out other governments. As the pressure on Germany increases, interest rates on Germany's debt have begun to increase. The increase reflects the potential that Germany will assume more responsibility for the debt of other EU nations.

German Chancellor Merkel has it half right. She's correct to insist the Central Bank (ECB) should not attempt to bail out individual governments. She is wrong to believe financial gimmicks, pledges and a single fiscal policy for the entire Eurozone will solve the problem.

Promises and pledges won't solve the problem. A lasting solution involves EU leaders making it clear what that each country's debt is the primary responsibility of that country. The more irresponsible a country's finances are, the more it will have to pay to borrow funds.

The immediate impact of such a move would be even higher interest rates on sovereign debt for the most irresponsible countries. There would also be significant losses for banks and others holding such debt. To contain problems, government regulators would have to ease bank capital requirements and take over the weakest banks to avoid widespread failures. The ECB would have to make sure there is sufficient liquidity (Euros) to maintain monetary stability.

With sharply higher interest rates on government debt, countries would be forced to cut pension and other welfare state commitments rather than just promise to cut them. Spending cuts represent the only viable long-term solution to the EU debt problems. Countries with the largest cuts in pension and welfare commitments would be the first to experience a decline in interest rates.

From a Keynesian perspective, EU leaders fear cutting government spending would weaken economic activity. Rather, it would boost activity. Funds now going to less productive government programs would become available to productive businesses. Until EU leaders are more inclined to adopt a more market-oriented solution, Europe's financial problems are likely to get worse.

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