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What size is the fire exit?

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The eurozone is being thrown into turmoil by a collective rush to the exits by investors. Yields on government debt of peripheral eurozone countries are skyrocketing, because investors do not really know what the risks are.

Officials want to be reassuring. Investors should not worry, they argue, because the current bailout mechanism – the European Financial Stability Facility (EFSF) – has worked so far without any haircuts for bondholders, and will continue to be applied until about 2013. Only after that date would any new mechanism open the door for losses for private investors, and only for debt issued after that date.

But markets do not trust this message – and for good reason: it is not credible, because it makes no economic sense. After all, the claim that the risk of loss will arise only for debt issued after the new crisis-resolution mechanism starts in 2014 implies that all debt issued until then is safe, and that insolvency can occur only in some distant future, rather than now, as in Greece and Ireland. In effect, EU officials are saying to investors, "Whom do you believe – us or your own eyes?"

Moreover, for too many investors, Portugal, with its poor growth prospects and insufficient domestic savings to fund the public-sector deficit, looks like Greece. And Spain clearly has to grapple with its own Irish problem, namely a huge housing over-hang – and probably large losses in the banking sector – following the collapse of an outsized real-estate bubble. The problems of Portugal and Spain might be less severe than those of Greece and Ireland, but this apparently is not enough to induce investors to buy their government debt.

A risk these countries share is thus the acute danger of large-scale runs on their banking systems. So far, investors trying to exit first have been made whole. Holders of Greek debt maturing now are repaid courtesy of the €110 billion bailout programme, and holders of Irish bank bonds have been given a guarantee by the Irish government, whose promises have in turn been underwritten by the EFSF. The EFSF will also provide funds to ensure that Irish banks' depositors can get their money back today.

The problem with this approach is that it creates the wrong incentives. Investors have now learned that the first to sell will avoid losses. The situation resembles that of a crowded cinema with only

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one exit. Everyone knows that in case of fire, only the first to leave will be safe. So, if the exit is small, even the faintest whiff of smoke can trigger a stampede. But if the exit looks comfortably large, the public will be much more likely to remain calm, even if parts of the room are already filling with smoke.

For the financial market, the size of the exit depends on the funds available to make short-term investors whole. Unfortunately, the size of the EFSF looks inadequate to finance a collective exit by short-term investors.

When the EFSF was created, it was assumed that the only problem was to ensure financing for the government deficits of the four prospective problem countries (Portugal, Ireland, Greece, and Spain). From this perspective, the headline figure of €750 billion allocated to the EFSF looked adequate.

But the EFSF's founders did not take into account banks' enormous short-term liabilities, which in a crisis effectively become government debt, as Ireland has been the most recent to demonstrate. The EFSF might be just enough to guarantee the public debt of the four problem countries, but certainly not their banking sectors' liabilities as well.

For example, the Spanish banking sector alone has short-term liabilities of several hundred billion euros. To return to the cinema analogy: investors know that the exit is not large enough to allow them all to squeeze through at the same time. So each one wants to be among the first to get out.

The official line so far has been "no default", meaning no sovereign default or that of any bank can be considered. If this line is to be maintained, the exit door must immediately be made much wider, and huge fire extinguishers must be brandished. The International Monetary Fund and the European Central Bank must show investors that they have enough funding to finance the simultaneous exit of all short-term investors.

It could work. A show of overwhelming force might restore calm to the markets. But it is a risky proposition: if investors exit nonetheless, the required funds might be so large that creditor countries' taxpayers' revolt.

The alternative is to change strategy and focus instead on investors' incentives. Patient investors should be rewarded. In particular, they should be able to expect to be better off than those rushing to the exit. This approach depends on two major policy shifts.

First, governments should not be pushed into insolvency just to save all banks. This means that the Irish government (maybe the next one) should demand that holders of bank bonds share the losses, perhaps by offering them a simple debt-equity swap.

Doubts about the Irish government's solvency would then disappear quickly, and its guarantee of bank deposits would no longer look so shaky. Something similar might have to be done for the Spanish banking system's exposure to the local housing market.

The second component of a permanent anti-crisis mechanism is a floor for bond prices – and thus a ceiling for losses. The yields and volatility of longer-term bonds should then fall relative to short-term securities, allowing peripheral governments to finance themselves reliably and at reasonable cost.

None of this would resolve Europe's fundamental problems, namely weak fiscal positions, poorly functioning financial sectors and lack of competitiveness. But all of them would be easier to manage with calmer financial markets.