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Interest Rates In France And Other Core European Countries Rise, Bring Europe Closer To Brink

By Bonnie Kavoussi

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The contagion of higher borrowing costs in Europe continued to spread on Wednesday, reaching even some of continent's strongest economies, raising national debt burdens and increasing the urgency for leaders to act decisively to stave off a potential economic meltdown.

Borrowing costs for typically financially stable countries such as France, the Netherlands and Finland soared on Wednesday. Investors fled for seemingly safer government bonds in Germany and the United States, as the long-feared flight of funds from the rest of the euro zone materialized.

"We're looking at a vote of no confidence by investors," said **Bernard Baumohl, chief global economist at the Economic Outlook Group**. As investors have been deserting European sovereign debt because they fear they would not be paid back in full, Baumohl said, interest rates have been rising.

Investors sharpened the divide between safe German debt and debt in the rest of the eurozone, as the difference between French and German interest rates on 10-year government bonds rose to a euro-era high of 1.89 percent on Wednesday. Interest rates on 10-year government bonds rose to 3.72 percent in France and 3.61 percent in Austria -- in contrast to an interest rate of just 1.83 percent on German sovereign debt.

"The contagion already has occurred. It's the event that everybody should have tried to prevent," said New York University economist Nicholas Economides. "Unless relatively low interest rates prevail in France, Italy, Spain, and so on, it will be hard for the euro to be held together."

As borrowing costs for most eurozone countries spike, European leaders are running out of policy options, according to some economists. Now European leaders either need to allow the European Central Bank to buy trillions of dollars in troubled government debt, or risk the breakup of the eurozone and an economic catastrophe.

German chancellor Angela Merkel said on Wednesday that she opposes more action from the ECB -- which has bought sovereign debt from troubled European countries such as Italy to keep down interest rates -- and the president of Germany's influential central bank said on Sunday that the ECB should not become Europe's lender of last resort. Meanwhile, the ECB recently slowed its purchases of troubled European government bonds, allowing interest rates to rise.

Nariman Behravesh, chief economist at IHS Global Insight, said that economic circumstances will eventually force the ECB to print money to buy large amounts of troubled sovereign debt. He said that if 10-year interest rates for Italy's sovereign debt stay above 7 percent -- they're currently at 7.12 percent -- then Italy will be in danger of insolvency in a matter of months, and the ECB will need to buy large amounts of Italian sovereign debt to allow it to continue to finance its borrowing.

"When push comes to shove, if the euro is at stake, this is something they [the Germans] are going to go along with," Behravesh said.

Behravesh said there is a 15 to 20 percent chance that Italy will default on its debt, which would endanger French banks that have invested a total $106.8 billion in Italian sovereign debt, according to the Bank for International Settlements. In that scenario, French banks would need a bailout from the ECB and the French government, or else they could fail, Behravesh said, freezing lending in European credit markets.

But Behravesh added that there is only a small chance that the euro would dissolve, plunging the continent into a deep recession, since the euro is too important to Germany to be allowed to fail. Ultimately, he said, the ECB would rescue the currency.

Under current European law, the ECB is not allowed to buy large amounts of sovereign debt directly from governments in order to save them from insolvency. The ECB is allowed, however, to buy sovereign debt indirectly from other investors, as well as bail out banks if necessary. Nonetheless, Germans have opposed drastic action from the ECB, since the ECB has a single mandate to curb inflation in the euro zone, and printing trillions of dollars to buy sovereign debt would inevitably raise prices.

In the end, **Baumohl** said, German leaders likely will put aside their aversion to inflation and support changing European law to allow the ECB to print large amounts of money to buy sovereign debt directly from troubled European countries. That would bring countries' borrowing costs down and allow the eurozone to stay together, he said.

"You can't drag out the current situation indefinitely because ultimately it's going to hurt the United States, it's going to hurt the Chinese economy, it's going to threaten to drag down the entire global economy into recession," **Baumohl** said. "The ECB has to balance between the risks of future inflation and stabilizing the financial system in Europe, but the priority will be to stabilize the financial system."