

LESSONS FROM EUROPE'S DEBT CRISIS FOR THE UNITED STATES

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The European sovereign debt crisis offers a cautionary tale for the United States. This is the case since all too sadly the U.S. public finances appear to be on the same sort of unsustainable path that lies at the heart of the present European crisis. Whereas Europe, taken as a whole, currently has a budget deficit of around 3 percent of GDP and a gross public debt ratio of around 90 percent of GDP, the United States has a budget deficit of around 8 percent of GDP and a gross public debt ratio in excess of 105 percent of GDP.

This article attempts to draw out those lessons that are most pertinent to the present U.S. context of worse overall public finances than those in Europe. The first part of this article traces the origins of the European debt crisis. The second part explains why the recent pledge by the European Central Bank “to do whatever it takes to save the euro” through large-scale purchases of Italian and Spanish bonds is unlikely to resolve that crisis. The final part of the article sets out the relevant lessons that the United States might draw from the European crisis with a view to avoiding a similar fate to the struggling countries in the European periphery.

Origins of the European Debt Crisis

In January 1999, at the launch of the euro, Milton Friedman expressed the gravest of misgivings as to how the European

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Monetary Union (EMU) would operate in practice. However, it is highly improbable that, even in his darkest moments, he would have anticipated how poorly EMU's internal policing of member countries' macroeconomic policy would have worked and how miserably the markets would have failed to exert discipline over wayward fiscal behavior of individual EMU member countries. Nor would he have anticipated the staggering degree to which imbalances would have been allowed to buildup in those countries' public finances and external positions.

In 1992, before the start of EMU, the Maastricht Treaty had set out strict limits for member countries' public finances in recognition of the need for sound economic policies within a currency union. Budget deficits were not to exceed 3 percent of GDP while the level of public debt was to be contained to below 60 percent of GDP. Sadly, over the past decade, these limits were observed in the breach. According to the European Commission, by 2009 Greece and Ireland registered public deficits of the order of 15 percent and 14 percent of GDP, respectively. At the same time, the public deficits in Spain had reached 11.5 percent of GDP, while Portugal's was nearly 9 percent of GDP (European Commission 2012).

The emergence of massive deficits in the European periphery has placed the public finances of the periphery on a clearly unsustainable path and has created great difficulties for these countries in the financial markets. The unsustainable nature of the periphery's public finances is most apparent in the case of Greece. Despite a 74 percent write down in Greek government private sector debt obligations at the beginning of 2012, Greece's public debt to GDP has now reached over 160 percent or more than two and a half times the Maastricht Treaty's 60 percent of GDP limit. However, the public finances of Ireland, Italy, Portugal, and Spain are also on unsustainable paths that have required the adoption of multiyear programs of severe budget austerity.

A second area where extraordinarily large imbalances emerged in Europe's periphery has been in the housing markets of Ireland and Spain. Fueled by easy access to global credit, as well as by an ECB whose one-size-fits-all interest rate policy kept interest rates too low for too long for Europe's periphery, Ireland and Spain experienced housing bubbles that made the U.S. housing bubble pale in comparison. Whereas housing prices in the United States increased by around 80 percent between 2000 and 2006, those in Ireland and

Spain approximately trebled. And whereas employment in the construction sector peaked at around 6 percent of the labor force in the United States, that in Spain reached as high as 18 percent in 2005. The bursting of the housing bubbles in Ireland and Spain has been a primary driver in the dramatic deterioration in those countries' public finances. It has also been the primary factor in the rise in unemployment in Ireland and Spain to their present levels of around 15 percent and 25 percent, respectively.

The lack of macroeconomic discipline in Europe's periphery has also given rise to the emergence of acute external vulnerability. Over the past decade, a generally too easy monetary and fiscal policy stance has caused wage and price inflation in the European periphery to be consistently higher than that in EMU's more fiscally conservative members. As a result, over the past decade, Greece, Spain, Portugal, and Ireland have all experienced a loss in international labor cost competitiveness of at least 20 percentage points. This loss of competitiveness, together with a worsening performance in public sector savings, manifested itself in gaping external current account deficits that in 2009 were well into double digits as a percentage of GDP for Greece, Spain, and Portugal.

Fiscal Austerity in a Euro Straitjacket

The essence of the European response to its sovereign debt crisis has been the attempt to cure the peripheral countries' underlying public debt and external imbalances by the pursuit of severe fiscal austerity within a euro straitjacket. That straitjacket has precluded those countries from devaluing their currencies to boost exports as an offset to the negative effects on output from severe fiscal tightening. It has also not helped that severe fiscal austerity is being pursued at a time that the European banking system is experiencing a credit crunch and at a time that countries like Spain and Ireland are in the full throes of housing market busts.

From the very beginning of the European debt crisis in early 2010, the European policy response has consistently been guided by the principle of conditioning bailout support to the implementation of rigorous fiscal austerity. This has been the case in all of the IMF-EU bailout programs for Greece, Ireland, and Portugal, as well as in the EU's most recent financial support program for the Spanish banking system.

Fiscal austerity has also been made the requirement for any eventual movement to a European fiscal union and for additional ECB support. To that end, at the December 2011 European Summit, a “fiscal pact” was adopted that committed all euro member countries to balance their budgets over the next few years. The attainment of that objective was to involve multiyear budget tightening of as much as 2 to 3 percentage points of GDP a year for countries like Spain, Italy, and Portugal, notwithstanding the fact that these three countries are all experiencing serious economic recessions and meaningful domestic credit crunches. In this context, it might be emphasized that the IMF’s latest research indicates that the fiscal multiplier in the European periphery is more of the order of between 0.9 and 1.7 rather than the 0.5 estimate on which the IMF’s lending programs had been based. The mid-point of the IMF’s latest estimate for the fiscal multiplier would imply that the fiscal tightening being envisaged for Portugal, Spain, and Italy in 2013 could in and of itself reduce economic growth in those countries by anywhere between 2.25 and 4.5 percent (IMF 2012).

The clearest of fault lines are now appearing in Europe’s single currency project that has to cast doubt upon the long-run survivability of the euro in its present form. For not only does the European fiscal austerity pact appear to be driving the European periphery into an ever more serious downward economic spiral, poor economies across Europe are undermining the European political center’s authority to pursue coherent economic policies. Increased political change in the European periphery is also now starting to exacerbate Europe’s economic downturn by making it difficult to govern, and by heightening market uncertainty about the periphery’s political ability to stay the course. Sadly, there appears to be nothing on the European horizon that offers hope that this economic and political downward spiral is soon to be arrested.

The underlying reason for tying bailout packages to budget austerity has been to assure the electorates in countries like Germany and the Netherlands that the European core countries would not be called upon to finance a bottomless pit in the periphery. However, a basic flaw with this approach has been that major fiscal austerity is being imposed on countries that are already in recession, that are stuck in a euro straitjacket, and that are experiencing domestic credit crunches.

More than two years into the crisis, it is clear that Europe's fiscal austerity strategy is not working. The clearest example is in Greece, where the economy has already contracted by over 20 percent from its 2009 peak, and where the IMF now expects that the economy will contract by a further 12 percent in 2012–13 (IMF 2012). However, deepening economic recessions are also very much in evidence in Italy and Spain, Europe's third and fourth largest economies.

Deepening recessions in the European periphery are fueling a veritable political backlash against austerity, which is being manifested in a dramatic erosion of the political authority of the traditional political parties. Once again, Greece provides the clearest example of this tendency. Whereas in 2010, PASOK and the New Democratic parties commanded 75 percent of the overall Greek vote, these two parties received barely 35 percent of the Greek vote by May 2012. By contrast, there has been a dramatic rise in the fortunes of parties on the extreme left and right of Greece's political spectrum.

While Greece provides the clearest example of the adverse political winds that are now blowing in Europe, it is far from an isolated case. Over the past two years, some nine sitting EMU governments have fallen as bailout fatigue has set in across the continent. And more troubling yet, there has been a clear increase in public support for populist parties in countries like Finland, France, Italy, and the Netherlands. Those populist parties are presently all waging campaigns against the euro. Given Europe's proposed unchanged economic policy mix for the periphery for the foreseeable future of severe fiscal austerity within a euro straitjacket, one has to expect a continuation of the periphery's downward economic and political spiral. This has to raise questions about the periphery's longer-run political ability to remain within the eurozone.

Has the ECB Saved the Euro?

At the end of July 2012, in response to a reintensification of the European sovereign debt crisis, Mario Draghi, the president of the European Central Bank, indicated that the ECB would do "whatever it took" to save the euro. This announcement, together with the ECB's subsequent policy elaboration on September 6, 2012, has succeeded in calming financial markets over the past few months by substantially reducing yields on Spanish and Italian bonds.

Under its new policy initiative, the ECB is committed to keeping short-term sovereign borrowing costs for all European countries that are undertaking serious policy adjustment in reasonable bounds in an effort to avoid their public finances from becoming unsustainable. It will do so for countries with strict economic adjustment programs by buying unlimited amounts of those countries' sovereign bonds with a maturity of up to three years in the secondary market as might be needed. In order to assuage fears in the European core countries in general and in Germany in particular that the ECB is not going down the path of monetary financing of budget deficits, the ECB has been at pains to emphasize that its secondary market bond purchases will be strictly conditional upon the benefitting countries adhering to rigorous adjustment programs. Specifically, the ECB has indicated that it will only start supporting countries by bond purchases once those countries have negotiated adjustment programs with the European Stability Mechanism (ESM) with the aim of eliminating those countries' public finance and external imbalances. The ECB has also indicated that it would expect that the IMF will be involved in the design and the monitoring of the adjustment programs that are to be negotiated.

While the ECB's policy initiative certainly restored calm to the European sovereign debt markets, there are a number of reasons to question whether the ECB's bold policy action will in and of itself succeed in putting an end to a sovereign debt crisis that has plagued Europe for more than two years. Among the reasons for thinking that the European debt crisis is far from resolved are the following:

- While the ECB's program of sovereign bond buying will reduce sovereign interest rates in the periphery to more reasonable levels, it does very little to alleviate the strong recessionary forces presently in play in those economies. In particular, it does not reduce the degree of fiscal austerity that will be required of those countries in 2013. Nor does it address the problem of capital inadequacy in the European banks that is causing meaningful credit crunches throughout the periphery. One must expect that the mix of pro-cyclical fiscal and credit policies that countries in the European periphery will continue to pursue will lead to a deepening in the European economic recession in 2013 at a pace not dissimilar to that which occurred in 2012. This would seem to be particularly the case in the context of a slowing global economy.

- The announced ECB policies have done nothing to address a very difficult economic and political situation in Greece that could very well see that country exiting the euro. In particular, Greece's European partners would like to see Greece comply with the conditions of its second IMF-EU financial support program, which requires Greece to secure parliamentary approval of €11.5 billion, or 5.5 percent of GDP, in public spending cuts for 2013 and 2014. They would also like to see Greece obtain concrete results in the areas of labor market reform and privatization policies that have eluded Greece to date. The painful policy demands being made of Greece, in the midst of Greece's worst economic recession since the 1930s, is exerting a heavy toll on Greece's political stability, which has to raise questions as to the longevity of the present government, whose survival is vital for the continued receipt of IMF-EU loan disbursements.
- Mario Draghi has been at pains to emphasize that the support being offered by the ECB to purchase Italian and Spanish bonds on a massive scale is strictly conditional upon those countries negotiating externally monitored fiscal adjustment programs. It is far from clear whether political conditions in Italy and Spain will allow for the early negotiation of such programs without renewed market pressure on those countries. The February 2013 Italian election results have to raise questions about Italy's political willingness to continue implementing an adjustment program of budget austerity and structural economic reform. Similarly, against the backdrop of a weakening Spanish economy and an unemployment rate of around 25 percent, the Spanish government is likely to continue to consider that it would pay too high a political price for having to enter into an adjustment program with IMF involvement. Further complicating matters in Spain are the difficulties that the government is having with its regional governments in general and with the Catalanian government in particular. Under these circumstances, it would seem that Spain will approach the EU and IMF for a conditional program only when it is forced to do so by the markets.
- The ECB's proposed large-scale purchases of Italian and Spanish sovereign bonds are running into considerable resistance from the German public. While Angela Merkel is lending

Mario Draghi considerable political support for his proposed bond purchasing program, the German Bundesbank, which is much revered and beloved by the German public, is openly hostile to the ECB's proposed course of action. In the Bundesbank's view, the ECB's proposed bond buying would be tantamount to the monetary financing of government deficits at a time that the German Bundesbank already has more than €750 billion exposure to the European periphery through the ECB's TARGET2 accounts.

Lessons for the United States

As the European economy slides deeper into recession, it is none too early for the United States to draw cautionary lessons from Europe's painful budget experience, since the dismal state of the U.S. public finances now bears an uncomfortably striking resemblance to that of the worst performers in the European periphery. And the United States would be ignoring those countries' difficult experiences with addressing high budget deficits at its peril.

The most common lesson that many observers draw from the recent European experience is that the United States must at all costs avoid the fiscal profligacy of a country like Greece if it is to avoid painful fiscal retrenchment. Sound as that lesson might be, a basic problem is that the U.S. train of fiscal recklessness has long since left the station. As a result of unchecked public spending over many years, including the financing of two unfunded wars, together with tax cuts that the country could ill-afford, the U.S. public finances are now widely perceived as being on a clearly unsustainable path.

According to the latest IMF estimates, the U.S. budget deficit will still be around 8 percent of GDP in 2012, or little different from that expected in Greece, and more than twice the average European level in 2012. At the same time, the IMF estimates that by the end of 2012 the U.S. general government debt will be around 105 percent of GDP or some 15 percentage points of GDP higher than the corresponding average public debt level in the euro zone (IMF 2012). More disturbing still, there is every indication that this disparity will widen in the years ahead on account of the increased strain on the U.S. budget deficit from its lavish entitlement programs.

It is also late in the day for the United States to draw the lesson from Europe that excessive credit and housing market bubbles,

whose bursting are at the core of Spain's and Ireland's present budget difficulties, can give rise to the need for massive fiscal retrenchment. Though perhaps not on quite the same scale as that in Ireland and Spain, between 2000 and 2006 the United States experienced such credit and housing market bubbles in spades. The subsequent bursting of those bubbles was the fundamental cause of the Great Recession in 2008–09, which has wreaked havoc with the country's public finances.

A common misconception about the European sovereign debt crisis is to blame Europe's present woes on the relatively high level of its public spending. However, an examination of the data would suggest that there is little positive correlation between the level of a country's public spending and its budget deficit. Indeed, while Europe's overall public spending as a percentage of GDP exceeds that of the United States by over 6 percentage points, Europe has a budget deficit that is half the size of that in the United States in relation to its GDP. And countries like Germany and Sweden, which epitomize the welfare state, have budget deficits that are less than 1 percentage point of GDP. While high public spending levels in Germany and Sweden are inimical to long-term economic growth, those countries have maintained tax rates that have been sufficiently high to finance such public spending levels without undue resort to deficit financing.

An important lesson that the United States can draw from the recent European experience is not to be lulled into a false sense of budget complacency by the extremely low long-term market interest rates at which the U.S. government can presently fund itself. Those low rates should certainly not be used as by the United States as an excuse to delay any further the adoption of a credible program of medium-term budget adjustment. As recently as 2009, the Greek government was still able to fund itself on a long-term basis at a mere 20 basis points above the corresponding rate at which the German government could do so (Bloomberg 2012). And it could do so despite growing evidence that the Greek public finances were on a clearly unsustainable path. When markets did finally turn against Greece, they did so in a dramatic fashion, which has highly complicated Greece's task of restoring order to its public finances. Considering the high proportion of the U.S. budget deficit that is financed from abroad, the U.S. would be making the gravest of policy mistakes not to pay heed to its acute budget financing vulnerability.

Another highly relevant lesson from the European experience is how painful budget adjustment has been within the euro straitjacket. That straitjacket has precluded member countries from the use of an independent monetary and exchange rate policy as an offset to the adverse impact of budget tightening on economic activity and employment.

As the latest IMF projections suggest, the recessions in Italy and Spain, which are stuck in the euro, are proving to be much deeper than that in the UK, which is also engaged in an aggressive medium-term fiscal consolidation program but which is not similarly constrained by euro membership from actively using monetary and exchange rate policy as an offset to fiscal tightening. This experience would provide support for the view that when the United States does embark on a serious program of medium-term fiscal consolidation, it should continue to be supported by a highly accommodating monetary policy stance by the Federal Reserve, which should not be prematurely withdrawn. A further important lesson that the European experience offers is that the speed and composition of budget adjustment do matter. Excessively front-loaded fiscal adjustment programs, such as those in Greece and Portugal, have led to deeper economic recessions than those in countries where budget adjustment has been more back-loaded. Similarly an excessive reliance on tax increases in general, and on indirect tax increases in particular, appears to have proved to be more harmful to economic output and employment than programs more focused on public spending cuts.

Europe's present economic difficulties are contributing to historically low U.S. government borrowing rates as investors seek safe havens for their investments. The United States would be making a grave mistake to be lulled into a false sense of security by those low rates. Instead, the United States would do well to take advantage of these low interest rates to start a serious program of medium-term budget retrenchment rather than to allow those low interest rates to lead the country further down the path to fiscal ruin.

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