Lessons from the Eurozone Debt Crisis

The eurozone debt crisis is still unfolding. No one knows how or when it will end. But already economic lessons have been taught.

The first is that economic (monetary) integration without political (fiscal) integration is a flawed union. A common currency for Europe was a commendable idea, especially as it was an attempt to enmesh countries whose rivalries had triggered two world wars. But to work it needed to be done under a federal political system like Australia's because this allows seamless fiscal transfers across the unified region. Like Greece and Ireland, California has struck serious debt and economic problems, but Washington's largesse (health and welfare payments, federal wages, etc.) supports the state. No such non-repayable money automatically flows into Greece, Ireland, Spain or Portugal from Brussels. Many of the solutions to the eurozone debt crisis are thus, in theory, political.

A second lesson is that countries that use a stateless currency such as the euro have limited ability to respond to economic troubles. They have no independent monetary policy, nor a currency that can plunge to make their economies more competitive. Their government's only levers are fiscal policy and any powers that can help deflate their economies, the recourse known as an "internal devaluation". That's when governments impose deflation by such measures as cutting public-sector wages and lopping social security benefits at the same time they are imposing austerity measures. As Greece, Ireland, Spain and Portugal show, people protest loudly when their wages and benefits are slashed or retirement ages are boosted. A floating national currency offers government a much more politically viable option for making a country competitive. For whatever reason, people don't see a plummeting currency for what it is; a cut in national income.

Another lesson, and one that should surprise no one, is that austerity programs kill sick, and even not-so-sick, economies. They thereby worsen, rather than fix, government finances, rendering IMF-style rescue pointless. The fiscal cuts Athens imposed as part of its 2010 bailout have torpedoed the Greek economy and consequently, as tax payments dropped and welfare expenditure soared, widened its budget deficit to about 10% of GDP, beyond the 7.5% target set for 2011 in last year's bailout package. That why Greece's bond yields are double what they were when it accepted an EU-IMF bailout in May last year, and the ratio of government debt to GDP is soaring towards 160% this year from 110% last year. The austerity package Greece just passed has been slammed as an "economic suicide pill" by many economists because it likely to make things worse. The UK is discovering this economic truth after its government imposed an austerity program in 2010 to rein in its budget deficit and debt even though it faced no crisis. Yet many in the US are calling for austerity to fix the country's government financial woes even though the economic recovery there is feeble.

Private trouble

Another lesson from the eurozone is that excessive private debt can be as poisonous as too much government debt. Greece floundered because its government ran (and hid) unsustainable fiscal deficits, as did Portugal. But authorities in Spain and Ireland were fiscally prudent – Ireland ran budget surpluses until 2007 and had reduced government debt to 30% of GDP by the mid-2000s. But Irish and Spanish banks were reckless. They lent too much for property development and created property bubbles that burst and, in exploding, crippled their banks, economies and government finances. This is a warning to Australians. We are smug that our

net government debt will only peak at 7.2% of GDP this financial year.[1] Yet most are oblivious to the fact that our net foreign debt – which is largely bank debt – stood at $677 billion, equal to 52.4% of GDP, at the end of March. Australia's financial system is at risk, if ever circumstances arise where foreign investors don't want to roll over maturing net private foreign debt worth $529 billion at the end of March (of which $358 billion was net bank debt).[2]

Then there's the lesson that it's ok for governments to guarantee bank deposits but dangerous to guarantee bank debt. Australia was one of many countries that in 2008 guaranteed bank deposits so people would think their savings were safe. Around the same time, Australia was one of many countries to stand behind bank debt so financial institutions could access money on global financial markets at a turbulent time. So far, so good for most. But Ireland showed how haywire such pledges for bank debt can go. On 29 September 2008, when Irish bank debt was selling for half its face value, the Irish government decided to support its tottering banks by guaranteeing bank debt. All this private debt then became public debt. With one decision that has been slammed as "economic treason" and likened to using the Irish people as "collateral", Dublin wrecked the Irish economy for – let's be optimistic – at least a generation.

The last, and most contentious, lesson offered here – and one that is yet to fully play out – is that it can be better for troubled economies to default than accept emergency help that is conditional on punishing their populations with austerity programs. (Remember too that "restructuring" is just a nice word for a partial default.)

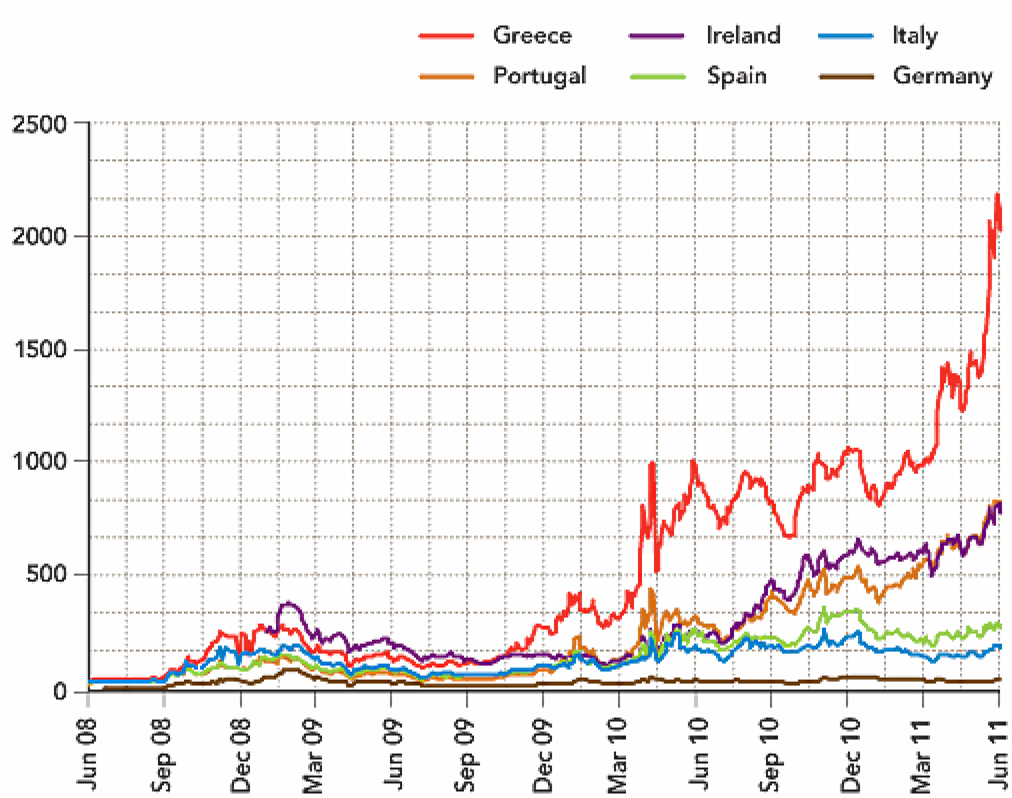
Iceland serves as one example of how this option can help resolve a financial crisis. The country's banks were 10 times bigger than Iceland's economy when they collapsed in 2008, so vast that the government refused to take responsibility for these private debts. So creditors lost money. After contracting 7% in 2009, with IMF loans and a 50% drop in the krona, Iceland's economy is recovering now.

Argentina's experience, which was a sovereign default, is similar. At the end of 2001, the South American country defaulted on debt and snapped the peso's currency peg (a similar constraint as belonging to the euro) to escape an IMF-imposed recessionary spiral. It duly did thanks to the lower currency helping commodity exports.

Some conditions need to be met for a government to be better off defaulting, such as its budget needs to be at least in balance before allowing for interest payments. (Greece isn't there yet.)

The eurozone debt crisis was largely caused by French and German banks underestimating the risks of lending to peripheral European economies. So, in principal, why shouldn't they be punished for their recklessness? Surely these bankers need to learn some lessons too.

CDS spreads widen for the eurozone peripheries



Bloomberg. 29 June 2011.

1 Wayne Swan, Treasurer of Australia. Budget Speech 2011-2012. 10 May 2011

2 Australian Bureau of Statistics release, “Balance of payments and international investment position”. March quarter 2011. 31 May 2011