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Fiscal problems in a number of European countries have raised concerns about long-term economic performance and the future of the eurozone

BY ROSS LAWRENCE

Concerns about sovereign debt — essentially, the debt of national governments — in Europe have spread briskly. For many in the United States, perhaps the most disconcerting element of the debt crisis is that fiscal spending, debt repayment, and currency valuation issues thousands of miles from home can have real implications for the American economy. Investors, for instance, recall the Russian default of the late 1990s and the turmoil that followed in financial markets.

How did fiscal problems in southern Europe become so severe, raising concerns about the sustainability of the economic recovery in the region? And how did the euro, a currency that some economists and policymakers once speculated could replace the dollar as the world reserve currency, lose nearly a quarter of its value against the dollar during the past two years?

Timeline of the Crisis

In October 2009, the Socialist Pasok Party won the Greek national elections in a landslide, ousting a center-right government plagued by both a corruption scandal and growing economic turbulence. With Greece under new leadership, its government began revising the country's questionable budget outlooks. It adjusted the projected deficit to 12.7 percent of GDP, more than double the deficit projection submitted to European Union (EU) officials earlier in the year. In October, Greece drew a rebuke from the European Commission for failing to meet its deficit targets. European Economic and Monetary Union (EMU) member countries are generally expected to maintain annual deficits totaling no more than 3 percent of GDP, although some leeway is often granted — Greece had claimed 3.7 percent to be its number earlier in 2009, for example. Also in October, Moody's Investor Services said it would review the country's A1 credit ratings and possibly lower them.

Throughout the final quarter of 2009, officials in Athens reviewed the budget and set goals for reducing the country's shortfall. A finalized budget submitted in November sought to cut the deficit to 8.7 percent of GDP in 2010, a move Prime Minister George Papandreou and his finance minister, George Papaconstantinou, hoped would signal their commitment to reorganizing the country's public finances. But at the same time, forecasts about Greece's debt-to-GDP ratio, the relationship between a country's total outstanding debt and its annual GDP, concerned many. The government's own estimates placed that number at 121 percent in 2010, while EU forecasts saw debt to GDP rising to 124.9 percent that year. In December, the major credit-rating firms — Fitch Ratings, Standard & Poor, and Moody's — each downgraded Greek debt.

During the first quarter of 2010, Greece continued taking steps to curb the looming crisis. The government's policy moves were not enough to allay investors' fears, however, in part because austerity measures — which included public-sector pay cuts, higher excise taxes on cigarettes and alcohol, and stricter retirement rules — prompted large-scale protests that seemed to threaten the government's capability to enact serious change. On March 25, European leaders

ILLUSTRATION: COURTESY OF NATIONS ONLINE PROJECT

agreed to create a joint financial safety net with the International Monetary Fund (IMF) that would allow Greece to receive coordinated bilateral loans financed jointly by both EMU member countries and the IMF. That action would occur only if the situation deteriorated further and was subject to several stipulations, such as Athens exhausting its other borrowing options. Nevertheless, on April 27, S&P downgraded Greek bonds to "junk" status, indicating it saw Greek debt as increasingly risky.

Fiscal troubles have not been limited to Greece. Two other southern European countries — Portugal and Spain — also have faced significant fiscal challenges. When Moody's put Greek credit ratings on review in October 2009, it changed the outlook on Portuguese debt to negative. More recently, in the second quarter of 2010, both Spain and Portugal received downgrades, with further downgrades for both countries and Ireland into the fall. (Ireland's fiscal situation worsened sharply in November, the consequences of which were still developing as this article went to press.)

Response and Outlook

The most ambitious move by the EU came in May, as European officials agreed to a nearly $1 trillion rescue package of government-loan guarantees for the continent. Leaders intended for the coordinated intervention in government bond markets to send a signal of the EU's commitment to fledgling financial public finances in Greece, Portugal, and Spain. For Americans, the EU's move may sound startlingly similar to some of the policies the United States enacted in 2008 during the financial crisis, albeit with a few key differences. "There are certainly parallels between the European rescue package and the U.S. bailout," said Guillermo Calvo, an economist at Columbia University and former chief economist at the Inter-American Development Bank. "But there are important differences, as well, other than the recipients. Conditions in Europe and the United States are different — the dollar is still the world reserve currency, for one."

The rescue package and other policy moves may have reduced the threat of another recession caused by European financial turmoil, at least for the time being, Calvo says. But that is not to say that policymakers or investors are out of the woods. "There are a lot of policies in play. Their results are uncertain over the short term, and definitely over the longer term," said Robert Carpenter, an economist with the Federal Reserve Bank of Richmond and the University of Maryland, Baltimore County. "In my opinion, the evidence suggests that market participants view the risk of Greek default as moderate to high."

Sovereign Debt in the European Monetary Union

Outstanding central government debt as a share of 2009 GDP

Country	Debt
Greece	125.7
Italy	106.6
Belgium	95.3
Portugal	81.1
United Kingdom*	75.1
Austria	64.3
France	60.8
United States*	53.1
The Netherlands	49.9
Spain	46.1
Ireland	46.0
Germany	43.8
Finland	37.6
Slovenia	34.1
Slovak Republic	33.6
Luxembourg	8.6

NOTES: *The United States and the United Kingdom are not EMU members.
Cyprus and Malta are members of the EMU but not the OECD and are not included on this chart.
SOURCE: Organization for Economic Co-operation and Development

Desmond Lachman, an economist with the American Enterprise Institute, a Washington, D.C.-based think tank, argues that the rescue package may help "kick the can forward" but that significant changes will be required, and those may be painful. "Greece must get its deficit down from 14 percent of GDP to 3 percent to be sustainable. That kind of fiscal adjustment could bring about deep recession, so it's a kind of trap that makes it very difficult."

That scenario could cause problems for Greece's neighbors. Greek debt sits on the balance sheets of France, Germany, and other Western European countries, Lachman says. The concern is not entirely about Greece, though. "The Greek economy is relatively small," says Calvo. "The fear is that if Greece goes, then Spain will be the next to fall." That could cause other eurozone countries, such as Germany, to waiver and refuse to make additional loans, Calvo argues. According to the IMF, as of 2009 Spain was the world's ninth-largest economy by nominal GDP, while Greece was number 28. The Spanish economy has been anything but robust during the economic downturn, with unemployment at roughly 20 percent.

Default is not inevitable, but the road to fiscal health and stability in Europe is a complex one to navigate. Austerity measures are one piece of the puzzle, but implementing them has proven difficult. Public-sector employees have protested in Greece, at times violently, and austerity measures only passed in Spain by a single vote. If such efforts become too politically contested in either country, there is a chance fiscal recovery efforts will be hampered significantly.

The rescue package is perhaps the most important policy move thus far in determining the trajectory of the crisis. Although the move seems to have quelled some distress, it remains an imperfect solution. "While crises may be contained through the injection of liquidity in the short run," Carpenter says, "the potential for moral hazard is made worse through bailouts, and now these bailouts involve sovereign states, who can pass the cost of their decisions to residents of other countries." Carpenter emphasizes that a bailout buys time, but that unless Greece adopts a more sustainable fiscal path, it may face future crises regardless.

The entire effect of the "Aegean contagion" on the United States remains to be seen. U.S. banks are not completely insulated from the situation in Europe, but the degree of the exposure is difficult to determine. Federal Reserve Chairman Ben Bernanke told members of the Joint Economic Committee that "exposures of U.S. banks via credit default swaps or direct

holdings to European governments is relatively limited." But some market participants are less sanguine. Banking analyst Richard Bove speculated in a research report that "big American banks have a bigger stake in this drama than thought." He estimated that J.P. Morgan Chase, the United States' second largest bank by consolidated assets, has $1.4 trillion of exposure across Europe, while the next largest, Citigroup, Inc, has $468.4 billion.

Although economists and investors disagree about the precise amount of American-bank exposure to Europe, there is little dispute that a systemic crisis in the EMU would be felt sharply across the Atlantic. "A European meltdown would be very bad for the United States," Lachman says. "There is not high exposure to peripheral sovereign debt, but a major European problem would cause U.S. banks to feel the effects. A declining euro also would hurt U.S. exports to Europe and could cause risk aversion in American markets."

The European Monetary Union: Past and Future

Although any country that maintains a high debt-to-GDP ratio risks financial turmoil, the common currency experiment in Europe makes the Greek, Portuguese, and Spanish situations particularly distinctive and unpredictable. One key limitation of being in the euro zone is that, for better or for worse, these countries cannot devalue currency to make debt repayment less painful.

The origins of monetary union in Europe date back to the 1992 Maastricht Treaty, which established provisions for a single currency, and the euro became legal, albeit at first nonphysical, tender for 14 European Union countries on Jan. 1, 1999. Six more countries, including Greece, would adopt the euro during the 2000s. The most notable nonmember is the United Kingdom, which still uses the British pound. For the other EU member states, the reasons for monetary union seemed compelling. "It would end forever the exchange-rate volatility that had bedeviled the continent since the breakdown of the Bretton Woods system of fixed rates in the 1970s," writes economist Niall Ferguson of Harvard University in an opinion article for the Financial Times. He also points out that proponents of the euro hoped it would end costly currency conversions and lead to greater price transparency that would improve intra-continental trade. But as Calvo, Ferguson, and Lachman each note, the geopolitical reasons were probably just as, if not more, convincing for member states. Centralized monetary control in theory would promote peaceful interdependence among European states, and it would create a currency powerful enough to challenge the U.S. dollar for world-reserve status.

For all the benefits of monetary union, however, the details still proved challenging. The biggest concern for most economists, it would appear, was the divorcing of monetary and fiscal policies — although the EMU established a single currency and thus a single monetary policy, there would be significantly less coordination in terms of member-state spending. Although convergence criteria were put into place and eventually codified with the Stability and Growth Pact, how such rules would be enforced remained unclear.

The sovereign debt crisis may provide the necessary spark for EMU members to discuss fiscal coordination policies in earnest, but any attempts to centralize authority likely will be met with resistance. "It will be difficult to achieve currency stability without fiscal harmonization," says Calvo. "They have been talking about doing this from the beginning, but I don't know how they are going to make it happen." Ferguson touched on a similar note. "What the Greek crisis has belatedly revealed is that such fiscal centralization is the necessary corollary of a monetary union," he writes, arguing that the choices before the EMU are much more fundamental than simply whether to bail out countries facing significant fiscal problems.

But if ever there was an opportunity to pursue fiscal coordination, now may be the time. "That's one of the benefits of these crises sometimes," Calvo says. "Things will be volatile for some time, but this crisis could spark the right policies in the end." Making such decisions politically possible is the crux of Europe's long-term recovery, but so far that has proven to be an elusive goal. **RF**

Readings

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