EUROPE IN A PICKLE

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EUROPE INC. is in a pickle. Greece appears poised to abandon the Euro and one or more other countries may follow. Judged on the basis of the latest information, economic growth is slowing throughout much of Europe and in some instances – most notably Greece and Portugal – already has turned substantially negative.

What's gone wrong? The problems began initially with the financial crisis and near worldwide recession five years ago. Tax revenues in the countries affected fell and transfer payments to the unemployed rose. For those reasons alone government budget deficits widened. Adding to the problem in some countries were the actions that governments took to prop up their nations' ailing financial systems. Ireland and Spain stand out in this regard.

In the case of both Greece and Portugal and to a lesser extent Italy, however, the governments' budgetary difficulties antedated the 2007-2008 financial crisis. The problems stemmed from continual high levels of government expenditures relative to tax receipts. A social welfare state in a society in which tax evasion and tax avoidance are national pastimes is ultimately a recipe for disaster.

Investors' perception dulled

To stem the gap between expenditures and revenues, a government in principle has two options—borrow by issuing bonds or print money. In a monetary union like the Euro area, individual countries like the individual US states cannot avail themselves of this second option. There is one central bank rather than a multiplicity of central banks with money-issuing authority.

Whether in practice a government can issue bonds and at what interest rate depends upon investors' perceptions of that government's willingness and ability both to pay the interest on those bonds and to repay the principal. If a bond issuer, be it a country or a US state, is judged more of a credit risk, the rate at which it can borrow will be higher than for a bond issuer with less credit risk.

Prior to the introduction of the Euro, countries like Greece, Italy, Portugal and Spain had higher bond yields than Germany and countries like Ireland and the Netherlands, whose central banks to varying degrees mimicked German monetary policy, had yields much closer to the level of German yields. With the adoption of the Euro, the situation changed rather markedly. Bond yields in all of the Euro-bloc countries converged and differences relative to German bond yields therefore narrowed to next to nothing. Table 1 shows these developments clearly.

Much too optimistic

Investors treated all borrowers within the Euro bloc as equally creditworthy. As things have turned out, that was quite a mistake. Their assessments of the relative degrees of country risk following the introduction of the Euro proved much too optimistic. As government budgetary problems have worsened, not only in Greece, Italy, Portugal and Spain but also in Ireland, spreads in bond yields relative to Germany have widened. In the case of Greece, as Table 1 again indicates, the spread is now almost 30 percentage points as the probabilities of default and of Greece leaving the Euro, devaluing the currency and inflating have increased. Whether the pessimism has gone too far in some instances has been a subject of debate. Time will tell.

A major underlying problem has been the single currency itself. For close to a decade the Euro exper-

Table 1. Differences in longer term government bond yields relative to Germany

	Greece	Ireland	Italy	Neth.	Portugal	Spain	Average
1994	13.83	1.05	3.65	-0.01	3.61	3.13	4.21
1999	1.81	0.22	0.24	0.14	0.29	0.24	.49
2006	0.31	0.01	0.29	0.02	0.16	0.03	.14
2012*	28.59	6.82	4.19	0.44	11.06	4.77	9.31

*   * Figures for 2012 are as of May 25

iment appeared to be a smashing success, so much so that those who were sceptical before the fact came in for increasing criticism as time wore on. The EU, however, is far from a homogeneous entity. Given that fact, a one-size-fits-all monetary policy – which is what the Euro bloc has – does not work well. Some countries like Ireland experienced higher inflation than others. Their products ended up being too dear relative to the products of other countries within the bloc.

As a result, they imported more than they exported. That works fine so long as a country experiencing a trade deficit of this sort can borrow abroad. If that ceases to be the case, then something has to give. If the deficit country has its own currency, it can devalue its currency. Doing so is not without problems but it may very well be preferable to have a decline in one price – the price of foreign exchange – than the alternatives of a decline in all prices, including wages and of movements of people and capital across national boundaries. In the shorter term, such downward pressures very likely will translate into declines in output if the adjustment of prices and wages is sluggish due, say, to the existence of longer-term contracts.

The Euro has proved to be simply one more example of a fixed-exchange-rate system. As small imbalances accumulate over time, pressures for revaluation/devaluation increase. This, in turn, leads investors to move funds out of the country, as the case may be with resultant dislocations to the economy in question.

Unavoidable political conflict

In this regard, Milton Friedman in 2001, the year before the Euro went into circulation, proved quite prescient. In a joint interview with fellow Nobelist Robert Mundell, Friedman said: "[If] as I fear is likely to be the case, over time, as the members of the euro experience a flow of asynchronous shocks, economic difficulties will emerge. Different governments will be subject to very different political pressures and these are bound to create political conflict, from which the European Central Bank cannot escape." Mundell was a good deal less prescient. According to Mundell "The advent of the euro has demonstrated to one and all how successful a well-planned fixed exchange rate zone can be."

The European elites' solution to the current problems is more of the same – a stronger political union and more stringent rules governing countries' fiscal behavior. This they believe will provide the panacea.

It's doubtful, however, that such moves will work. They will instead simply transfer more power to Brussels and in the process result in a further erosion of human freedom. *Caveat emptor*.