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A European Economic Tsunami?

By DESMOND LACHMAN and DALIBOR ROHAC
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In 2007, the chairman of the Federal Reserve, Ben Bernanke, spent most of the year assuring markets that the U.S. sub-prime mortgage loan problem would be contained. In an all-too-similar manner, the European Central Bank president, Jean-Claude Trichet, now keeps asserting that Europe's sovereign debt crisis does not pose a significant threat to the overall European economy, let alone to the global economy.

American policymakers would do well to disregard Mr. Trichet's sanguine remarks and brace themselves for a European economic tsunami that is all too likely to seriously derail the fragile U.S. economic recovery.

Among the surer signs that a currency arrangement is approaching the end of its useful shelf life is when policymakers are forced to vehemently deny the possibility of any change in that arrangement.

This week, as Ireland embarked on a highly unpopular austerity program, Chancellor Angela Merkel of Germany provided such a clear signal for the European Monetary Union. She did so when she led a chorus of European policymakers in asserting that it was impossible to conceive that any member country would ever exit the euro. Despite her assurances, markets remain singularly unconvinced that outsized I.M.F. and E.U. bailout packages for politically troubled Ireland and Greece will prevent those countries from eventually defaulting on their sovereign debts.

Contrary to what European policymakers would have us believe, events in Europe's periphery over the past year are vindicating Milton Friedman's deep skepticism about the euro, which he expressed at the time of its 1999 launch. He believed that given its flawed structure, the euro would not survive its first major economic recession.

What makes it all too likely that Friedman's misgivings will be proved correct is that over the past decade countries in Europe's periphery have consistently not managed their public finances according to the arrangement's rules. As a result, outsized budget and balance-of-payment deficits do not now simply characterize the Greek, Irish and Portuguese economies. Rather, more ominously, they also characterize Spain, which is aptly being described on Wall Street as being too big to fail yet also too big to save.

In a recent major shift in thinking, European policymakers now recognize that debt restructuring, albeit only beginning in 2013, will need to be part of a solution for addressing the periphery's large fiscal imbalances. However, they are yet to recognize that the major part of the periphery's budget deficits constitute "primary" or non-interest payment transactions. As a result, even were they to succeed in substantially writing down their debts, these countries would still be left with very sizeable budget deficits that would be extraordinarily difficult to correct in a fixed exchange rate arrangement.

The late American economist Herb Stein was fond of observing that if something cannot go on forever, it will stop. This aphorism appears particularly apt for the current state of the euro area. It seems unreasonable to expect that voters in Europe's north, and especially in Germany, will indefinitely acquiesce to the transfer of large amounts of bailout money to the south in an effort to keep those countries afloat.

And it seems even more unreasonable to expect voters in the south to indefinitely endure the severe economic and social pain associated with continued euro membership and the I.M.F. austerity measures attached to the financing they receive from the north.

European policymakers understand full well that a wave of sovereign debt defaults in Europe's periphery would more than likely precipitate a full-blown European banking crisis, since European banks are the main holders of the $2 trillion in the periphery's sovereign debt.

This suggests that European policy makers in the north will not lightly turn off the financing spigot that presently keeps the periphery afloat. However, judging by the crushing defeat handed Ms. Merkel in the May 2010 Westphalia state election, electoral considerations will likely make it all but impossible to indefinitely continue such financing.

The more likely trigger for the euro's eventual unraveling will be in the periphery itself. The

Greek, Irish, Portuguese and Spanish governments all have tenuous holds on political power. And as recent events in Ireland seem to be bearing out, a deepening in the periphery's economic and financial crises could very well result in the ascent of more populist governments, which might be less willing to hew to the hair-shirt austerity programs dictated by the I.M.F. Recall the spectacular demise of Argentina's "immutable" currency peg to the U.S. dollar in 2001 after a futile attempt to effect a large-scale I.M.F.-imposed budget deficit adjustment in defense of that peg.

An escalation of the European debt crisis would pose a real threat to U.S. economic recovery. A weakened euro would seriously dent U.S. export prospects. Of greater concern, a European banking crisis would threaten to contaminate the rest of the global financial system in much the same way as the Lehman Brothers fiasco did in 2008. With the darkest of economic storm clouds gathering in Europe, this is no time for U.S. policymakers to be thinking of cutting back on policies to support the U.S. economy.

Desmond Lachman *is a resident fellow at the American Enterprise Institute and the author of "Can the Euro Survive?," published by the London-based Legatum Institute, where Dalibor Rohác is a research fellow.*