Europe's Lehman moment

September 16, 2011 @ 6:47 pm

By Jeffry Frieden

By Jeffry A. Frieden
The opinions expressed are his own.

Europe is in the midst of its variant of the great debt crisis that hit the United States in 2008. Fears abound that if things go wrong, the continent will face its own "Lehman moment" – a recurrence of the sheer panic that hit American and world markets after the collapse of Lehman Brothers in October 2008. How did Europe arrive at this dire strait? What are its options? What is likely to happen?

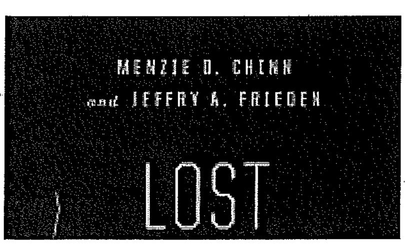
Europe is retracing steps Americans took a couple of years ago. Between 2001 and 2007 the United States went on a consumption spree, and financed it by borrowing trillions of dollars from abroad. Some of the money went to cover a Federal fiscal deficit that developed after the Bush tax cuts of 2001 and 2003; much of it went to fund a boom in the country's housing market. Eventually the boom became a bubble and the bubble burst; when it did, it brought down the nation's major financial institutions – and very nearly the rest of the world economy. The United States is now left to pick up the pieces in the aftermath of its own debt crisis.

Europe's debtors went through much the same kind of borrowing cycle. For a decade, a group of countries on the edge of the Euro zone borrowed massively from Northern European banks and investors. In Spain, Portugal, and Ireland, most of the borrowed money flooded into the overheated housing market. "At the height of the building boom," Menzie Chinn and I write in our new book, *Lost Decades: The Making of America's Debt Crisis and the Long Recovery*:

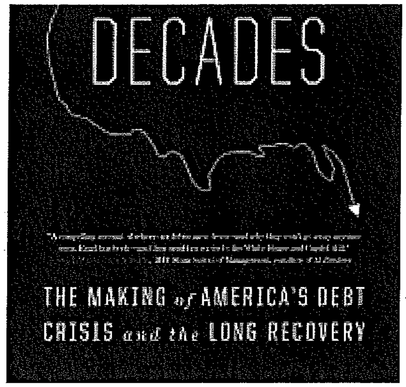
> One Spanish worker of every seven was employed in housing construction. Half a million new homes were being built every year—roughly equal to all the new homes in Italy, France, and Germany *combined*—in a country with about 16 million households. The amount of housing loans outstanding skyrocketed from $180 billion in 2000 to $860 billion in 2007. Over the ten years to 2007, housing prices tripled,second only to Ireland among developed countries; by then, the average house in Madrid cost an unheard-of $400,000. (pp. 49-50)

Greece was a different story. It borrowed, as we write, "mostly to finance a continual budget deficit and an American-style consumption boom."

> Greek borrowing went beyond the sensible: at its peak, in one year Greece borrowed an amount equal to nearly 15 percent of GDP, so that more than one euro in seven spent locally was borrowed from abroad. By 2009, the country's eleven million people owed more than $500 billion to foreigners, more than the foreign debts of Argentina, Brazil, and Mexico combined (with thirty times the number of people and ten times the economic output of Greece). (pp. 186-187)



[1]Europe's experience differs from that of America's because of the existence of the euro, a common currency for both the lenders and the borrowers. The monetary policy of the European Central Bank (ECB) kept interest rates very low, even for rapidly growing countries in Southern Europe that had previously had high interest rates. And the expectation that other members of the Euro zone would step in if a



debtor member state got into trouble led lenders to believe that lending within the Euro zone was close to riskless.

But as in the United States, the boom was not sustainable. When the global financial crisis began in October 2008, the European debtors were largely frozen out of financial markets. As their economies spiralled downward, they faced grave difficulties in servicing their debts.

The problems of Europe's debtors were not just worrisome for the debtors themselves. Most of their debts were owed to Northern European banks and investors, and the crisis threatened the very solvency of major European financial systems. This – not some abstract desire to extend a hand to the Greek and Portuguese people, or to save the euro – has been the principal reason for Europe's ongoing debt bailout:

> The rationale here was like that of bailing out a bank: a collapse of Greek or Portuguese finances could harm the rest of the euro-zone financial systems. If Bank of America was too big to fail, then so was Greece. And since a deepening of the financial crisis that drew in the entire euro zone would affect the entire global financial system, the International Monetary Fund was also drawn into the rescue....And because the Greek emergency triggered a crisis of confidence in other euro-zone countries whose failure could harm the region as a whole, the European Union was driven into a massive trillion-dollar package for other troubled European debtors. (page 188)

But the first bailout was not enough. It seems clear that the Greek and Portuguese austerity measures will not be sufficient to allow the countries to continue to service their debts; Spain seems on the verge of a similar slide into default; and even Italy is now at risk of going the way of the other debtors. Some or all of these debts will have to be restructured, the interest rates reduced and maturities extended. If not, there will be a wave of defaults whose reverberations will rival those of the Lehman failure.

For two years, Europe's governments have been grappling with how to address this continuing debt crisis. But most of the public discussions have been highly misleading. In Northern Europe, and especially Germany, the tone has been one of outraged indignation. This high moral tone is misplaced. Certainly many Southern European banks and households, and the Greek government, borrowed irresponsibly; but German and other Northern European banks and investors lent just as irresponsibly. It's not clear that there's any real ethical distance between irresponsible borrowers and irresponsible lenders.

And most Northern Europeans also seem to believe that the bailouts have gone to lazy Southern Europeans. In fact, their purpose has been to shore up the fragile Northern European financial systems. German banks are among the weakest in Europe; some of them (especially the state-owned landesbanks) are effectively bankrupt. If they were forced to mark down their Southern European debt, they might well collapse in a heap, and the European financial system could grind to a halt. Just as in the United States, the real impact of the European bailout has been to shore up the continent's banks – not to help the continent's debtors. The recent downgrading of two of France's most important banks, due to their holdings of Greek debt, reminds us of how exposed Northern Europe's financial systems remain. And rumors of a recent IMF report that European banks are over $270 billion short of the capital they need to confront their current problems served to drive the point home.

Some of the European debates end up considering whether the euro has been good for its members. Most Germans seem to think that the European Union has become what in Eurospeak is often called "Transfer Europe," a mechanism to channel honest Northern European money to lazy Southern Europeans. This makes it hard to understand why any German government would put up with such a thing. But it ignores the gains that Germany has realized by being the leading economy in the eurozone. For a decade, Germany's growth has come almost exclusively from its exports; and the eurozone and its periphery have been central to this export growth. German industrialists, at least, seem to believe that the euro has been crucial to their business. Just as bailing out Nevada and Florida may be the price people in Massachusetts and New York pay for sharing a continental economic and monetary union, so too does this calculation apply to Germany. Certainly many Germans would prefer not to have to contribute to resolving the European crisis; but these skeptics seem not to understand that the alternative might be, in the short run, a gut-wrenching collapse of the German banking system, economic distress in the rest of the eurozone, and in the long run, a loss of a major source of German economic growth.

There is also an air of unreality about European discussions of how to deal with the debts themselves. In just about every debt crisis, the eventual workout requires both debtors and creditors to pay some of the price for crisis resolution. Delay in recognizing this only makes matters worse. In the aftermath of the Latin American debt crisis that began in 1982, the U.S. government tried to maintain the fiction that the debts would eventually be paid – forcing a decade of austerity on Latin America that led to the region's lost decade. Ultimately, in 1989 the George H. W. Bush Administration recognized reality and engineered a regional write-down that allowed the banks to get the bad debts off their books, and allowed the countries to resume growth.

Eventually Europe's creditors and its debtors will have to admit that these debts will not be serviced as contracted, and the debts will be restructured. Pretending otherwise will only prolong the agony – not just for the debtor countries imposing austerity, but also for the financial systems that are now crippled by debts that nobody believes will be repaid. When major central banks, earlier this week, threw a lifeline to the European financial markets, they undoubtedly helped avoid what appeared to be an imminent panic. However, this initiative will only postpone the final reckoning with the region's underlying financial weaknesses.

In Europe as in America, the real question is how the costs of this devastating debt crisis will be distributed. Who will pay – creditors or debtors? Taxpayers or government employees? Germans or Greeks? More realistically, what combination of sacrifices will be politically tenable, both across countries and within countries. The aftermath of every debt crisis sinks into conflict over who will bear the burden of adjustment to the new reality. The sooner Europeans recognize the true nature of the debates they're having, and the inevitability of working out some mutually acceptable conclusion, the better off they will be.

[1] Image: **http://blogs.reuters.com/great-debate/files/2011/09/LostDecades.jpg**