



## Europe's Sovereign Debt Crisis: No Place to Hide?

By John H. Makin

"No man is an Island, entire of itself; every man is a piece of the Continent,  
A part of the main; if a clod be washed away by the sea, Europe is the less, as well  
As if a promontory were, as well as if a manor of thy friends or of thine own were;  
Any man's death diminishes me, because I am involved in Mankind;  
And therefore never send to know for whom the bell tolls; It tolls for thee."

—JOHN DONNE, "Meditation XVII" in *Devotions upon Emergent Occasions* (1624)

John Donne's oft-cited 1624 sentiments, a compelling metaphor for systemic risk in highly integrated global financial markets, have been widely invoked during the rolling financial crisis that emerged in 2007. Talk show pundits have intoned—having noticed that Europe is undergoing a debt crisis—that America should beware: this same sovereign debt crisis could be coming to our shores.

Indeed, it is possible that the United States could be heading for its own debt crisis, complete with a collapsing government bond market that forces the Federal Reserve to print money rapidly enough to inflate away the real burden of large accumulated debt. A serviceable barometer for the likelihood of a government debt crisis is the ratio of net government debt to gross domestic product (GDP). That measure for the United States has risen from about 40 percent in 2008 to higher than 60 percent in 2010 and, more importantly, is on track to reach 80–85 percent by 2015.

Debt accumulation at that pace usually occurs only in wartime, and it constrains the ability of a government to cut taxes and spur growth or to maintain spending on "essential" programs. (I will not address the thorny issues surrounding

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discretionary fiscal policy here.) But for a modern economy with a well-developed tax-collection infrastructure—alas, in the American case, well provided by the Internal Revenue Service—the rise in the debt-to-GDP ratio from below 40 percent to above 80 percent over the course of six years is manageable, although not attractive. It need not lead to higher inflation, provided that a leveling off and subsequent reduction of the ratio is plausibly foreseeable. The huge rally in the market for thirty-year U.S. government bonds—up 8 percent in May alone—underscores the "manageable" view and strongly suggests an outlook for deflation, not inflation.

### Defining a Debt Crisis

A sovereign debt crisis—an unsustainable path for government finances—emerges when efforts to remedy the crisis actually make it worse. More specifically, a government debt restructuring or default is required when fiscal stringency (cutting the primary deficit by slashing government spending, raising taxes, or both—measures that have been proposed for Greece) actually raises the government's ratio of debt to GDP. Greece clearly satisfies the crisis criterion—and Portugal and Spain probably do—but Germany and the United States

do not; both countries' government bonds have risen in value as southern Europe's debt crisis has intensified.

Debt arithmetic determines the path of the debt-to-GDP ratio. The ratio rises faster as the interest rate on outstanding debt rises relative to nominal GDP growth and as the primary deficit (government spending on all but interest minus tax revenues) rises relative to nominal GDP. As the debt-to-GDP ratio approaches 100 percent (Greece's is now 120 percent), the effort to reduce it by cutting government spending, raising taxes, or both actually raises the ratio because it cuts GDP growth faster than it cuts debt. If, as in the case of Greece, the government's tax-collecting system is very weak, the problem is exacerbated simply because promises to cut the primary deficit are not credible.

The United States or Germany can "grow out" of the rising debt-to-GDP ratio by virtue of the credible prospect that nominal GDP growth will exceed the average (low) interest rate on outstanding government debt and because each country has a well-established tax-collecting system. That said, cuts in government spending are still preferable to tax increases as a way to cut the primary deficit because they produce less negative impact on sustainable growth—the best route out of a debt trap—than do tax increases, especially tax-rate increases.

Efforts to inflate out of the debt conundrum do not work because they boost interest rates as rapidly as they boost nominal GDP growth unless inflation surprises markets. This is not a likely outcome in view of the quick response by bond vigilantes to any signs that central banks are trying to inflate out of a debt crisis. This reality helps to explain why the inflationary European Central Bank (ECB) move toward quantitative easing over the May 8–9 weekend (more about this below) only reinforced the conviction that Greece will need to reschedule—that is, partially default—on its nearly €275 billion of outstanding debt. The possibility that the same may be true of Portugal and Spain led to an effort by European banks to dump those debts into the ECB. Although the quantity of southern European debt on offer to the ECB surged after the May 10 announcement of quantitative easing, the ECB appeared to have stopped buying the debt by May 14. The collapse in southern European debt prices reemerged as markets and the ECB, to its dismay, may have realized that the bank might have to buy most of the Greek,

Portuguese, and perhaps even Spanish debt—over €1.2 trillion worth of which is held by banks—to quell the crisis.

That amount of quantitative easing would be virtually impossible to sterilize fully. So, European inflation expectations have jumped, and the euro has dropped in value.

## Exchange Rates Absorbing the Euro Shock

In the end, both a Greek default or rescheduling and a weaker euro, leading to more inflation in the European Monetary Union (EMU), will be required to avoid a systemic debt disaster in Europe. Of course, the involvement of U.S. government officials and the Federal Reserve in the discussions that resulted in Europe's decision to bail out Greece through quantitative easing raises legitimate concerns about the

Fed's integrity and the prospects for U.S. inflation. That is why the price of gold is rising. For now, however, by virtue of the strengthening dollar versus the euro and the British pound, the United States is importing deflation—a development not entirely unwelcome to the Fed because it is also helping to push down U.S. interest rates and thereby contributing to a reduction in the pace of increase of the U.S. debt-to-GDP ratio. But the consequences are not all beneficial for the United States, which is on the cusp of core deflation. There could be negative consequences for highly indebted U.S. households as deflation boosts the real burden of debt.

For now, the flexibility of major currencies is buffering the United States and other nations from the potential contagion of the southern European debt crisis by addressing the acute need for reflation in Europe. An effort at coordinated currency intervention to slow or reverse the reflationary decline of the euro would be the equivalent of jamming the pressure release valve on an overheated boiler. Buying euros and selling dollars, as the ECB would have to do to strengthen the euro, defines a tighter money stance. The result would be to drain liquidity from European financial markets just after the ECB has undertaken a massive liquidity injection through large purchases of southern European bonds from European banks.

The ECB cannot add liquidity with one bond-buying hand and subtract liquidity with the other dollar-selling hand and expect to alleviate a severe liquidity shortage in European financial markets. The weaker euro is part of the

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solution to Europe's bank solvency crisis that has resulted in turn from a southern European sovereign debt crisis. It is not part of the problem for Europe, though the implied intensification of U.S. deflation may become more of a problem for the United States.

## The Japanese Experience

The Japanese demonstrated during the 1990s that a rapid rise in the debt-to-GDP ratio to well over 100 percent need not lead to either higher inflation or higher interest rates. In fact, the opposite—deflation and lower interest rates—has ultimately emerged. Any astute observer of today's southern European debt crisis has to be curious about the following question: why is Japan, with a debt-to-GDP ratio above 200 percent and rising, not experiencing a debt crisis like that of Greece, where the debt-to-GDP ratio is 120 percent? The answer lies with the determinants of debt arithmetic. Japan's interest rate on ten-year government bonds is 1.28 percent, so it is plausible that Japan's nominal growth rate, provided that it successfully reverses its deflation, will exceed that low level, thereby pushing the debt-to-GDP ratio down over time. Moreover, Japan's tax-collection machinery is far more effective than that of Greece.

## How Did We Get Here?

Understanding the reasons for the southern European debt crisis also provides some comfort that the crisis will not spread to the United States. Complacency, however, would be misguided.

The EMU was and is an experiment: can you engineer a fiscal union by imposing a monetary union first? The EMU was designed to capture the benefits of a single currency for Europe. The conditions for joining the EMU, outlined in the Maastricht Treaty, entailed maintaining a highly disciplined fiscal policy—specifically a stable debt-to-GDP ratio with deficits held at or below 3 percent of GDP. The requirement of fiscal discipline was essential because all EMU government debt denominated in euros was to be seen as an identically attractive store of value.

In effect, the ECB was to play the role of enforcer if and when a single EMU country violated the rules and allowed its deficits to swell rapidly enough to push up its

debt-to-GDP ratio. The critical point for enforcement was to come when fiscal discipline became so lax that interest rates on, say, government debt, even though it is denominated in euros, rose above interest rates on government debt for Germany, where fiscal policy was in compliance with EMU rules.

The 2008 global financial crisis, coupled with a growing divergence between labor productivity in Germany and southern Europe, imposed unbearable strains on the EMU. As discussed in the *May Economic Outlook*, the EMU's territory is not an optimal currency area, meaning that a single currency arrangement will probably break down under strains imposed by a shock like the 2008 financial crisis. Greece, the weakest link in the EMU, could not survive under a tight ECB monetary policy designed for a robust German economy without enduring vicious price and wage deflation. Instead, Greece ran larger and larger deficits that rose sharply with the onset of the financial crisis—so sharply that their size was

concealed by the Greek government, presumably in the hope that an end to the global financial crisis would bring relief. Ironically, Greece's decision to conceal the rapid deterioration of the country's fiscal conditions until 2010 has extended the global financial crisis. "No man is an island," especially in the EMU with its single currency.

Sadly, the ECB played the role of enabler in moving Greece, and perhaps most of southern Europe, to an unsustainable fiscal posture. As fears about Greek solvency rose, especially during 2009 and 2010, the ECB lowered its collateral standards to allow European banks to finance holdings of higher-yielding Greek debt at the same low interest rate on offer to finance German government debt (1 percent or below). The result was an ECB-accommodated surge in Greek borrowing largely from European banks. As questions surface about the sustainability of Portuguese and Spanish government finances, the same problem has arisen, leading European banks to accumulate more debts from those two countries. By the end of 2009, bank holdings of Portuguese, Spanish, and Greek bonds totaled €1.2 trillion, with a high concentration of holdings in German and French banks.

The ECB policy of treating all EMU government liabilities as perfect equivalents was seriously destabilizing. Because all EMU government bonds were denominated in

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euros and because that “could not” be the case unless all governments met the strict conditions of fiscal rectitude specified in the Maastricht Treaty and signed by all EMU members, it was appropriate to treat German and Greek government bonds as if they were the same by virtue of their denomination in euros. However, the statement “a euro is a euro” has been transformed into a question: is a euro more like a deutschmark, Germany’s former currency, or a drachma, Greece’s?

Once that question is asked, pressure begins to mount either for the issuers of government debt in southern Europe to leave the EMU or for the euro to lose value relative to other currencies. Those who ascribe to the global sovereign debt crisis view, whereby no man is an island, buy gold. The others buy U.S. Treasuries. Both moves are underway, as evidenced by a higher gold price and by lower yields on U.S. government bonds, with the latter tied, in part, to the persistent disinflationary trend in the United States that has nearly evolved into outright core deflation over the last six months.

The ECB’s response to the debt crisis in Greece and southern Europe has been destabilizing because it combined completely implausible denial of the problem—Greece can stay in the EMU while the euro remains a sound store of value—with what became, on May 10, a serious compromise of the integrity of the ECB.

## The Greek Fiscal Crisis Explodes

The Greek fiscal crisis—a speck on the horizon until late 2009—has risen exponentially in intensity to become a portent of a systemic financial crisis centered on the solvency of the mostly European banks holding the bulk of southern European government debt.

On April 11, the ECB and the International Monetary Fund (IMF) presented the “buy time for Greece” exercise, which opened with a €45 billion package designed to provide time for the Greek government to develop a program of fiscal stringency. By late April, it was clear that the rescue package was insufficient as southern European debt (especially that of Greece) dropped in value along with the euro. Signs of contagion emerged as Standard & Poor’s (S&P) downgraded Greek debt to junk status on April 27 and also downgraded Portuguese debt by two notches. On April 28, S&P downgraded Spanish debt from AAA to AA-. European banks, stuffed with southern European

governments’ debts, saw their stocks drop in value as analysts pored over Bank of International Settlements data to locate the holders of suspect southern European government debt. Another ECB-IMF package announced on May 2, set at €110 billion, was aimed at stabilizing the situation.

Nevertheless, the crisis intensified almost immediately because it was clear that unless the ECB agreed to purchase, outright, the debt of southern European governments, heavily owned by European banks, the solvency of those banks would be threatened. On Thursday, May 6, after a regularly scheduled meeting of the ECB Governing Council—that ironically was held in Lisbon according to a long-determined schedule to foster the appearance of EMU unity—ECB president Jean-Claude Trichet announced that ECB purchases of government bonds had not been discussed. Southern European government bonds collapsed in value, and Europe’s financial markets froze. Investors sold off stocks around the world as fears intensified of further contagion from Europe’s sovereign debt crisis.

Faced with such an overwhelming crisis, the EMU and IMF hastily assembled a “shock and awe” package of €750 billion (“a trillion dollars!” the headlines screamed in the United States) over the May 8–9 weekend to support the market for southern European debt. More critical than the large headline number—substantially provided by €440 billion of EMU guarantees of southern European debt—was the announcement that the ECB would directly purchase Greek, Portuguese, and Spanish debt. This meant that the ECB, Trichet’s unconvincing denials notwithstanding, had moved to direct purchases at well above market prices of the debt issued by governments whose fiscal policies were grotesquely in violation of Maastricht Treaty rules. This is quantitative easing.

Underscoring the compromise of ECB integrity entailed by that relief package, which had further reduced the likelihood of resolving unsustainable fiscal positions in southern Europe, three members of the governing council of the ECB voted against the decision to purchase the government debt: Deutsche Bundesbank president Axel Weber, heir apparent next year to the ECB presidency; his Dutch counterpart, Nout Wellink; and ECB chief economist Jürgen Stark.

In the space of three weeks (from April 12 to May 2), the marginal cost of buying time for southern Europe to move to a sustainable fiscal stance had risen by a factor of

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more than seven. On April 12, a €45 billion package bought three weeks of crisis respite at a rate of €15 billion per week. The May 2, €110 billion package bought a single week of respite. By May 14, the crisis had reintensified as the euro dropped sharply and investors sold southern European government bonds while the ECB paused in its purchase program. By then, a €750 billion package had bought less than a week's respite, fifty times the €15 billion weekly cost purchased with the April 12 package. That progression virtually defines a crisis.

Speculators who had been selling southern European government bonds were punished by the €750 billion package, but the loss of ECB integrity, due to what amounted to quantitative easing that they denied would occur, produced a sharp drop in the euro versus the dollar, from a peak of about 1.31 dollars per euro just after the €750 billion package was announced on May 10 to a low of about 1.24 dollars per euro on May 14. Markets had decided that the euro was moving away from hard, deutschmark status to soft, drachma status.

The credibility of the €750 billion ECB-IMF package is under increasing strain. On May 14, while the crisis was reemerging, three events underscored the inadequacy of the ECB approach to the sovereign debt crisis in southern Europe. First, the Spanish newspaper *El País* reported—without eliciting a denial—that French president Nicolas Sarkozy had threatened on May 9 to pull France out of the EMU unless Germany and the ECB got behind the rescue package then being hammered out. Second, Josef Ackermann, president of Deutsche Bank, which is heavily exposed to southern European debt, mused that perhaps Greece would not be able to service its debt after all. Finally, during a speech in London, Paul Volcker, former Federal Reserve chairman and a senior economic adviser to U.S. president Barack Obama, said in reference to the Greek fiscal crisis, “you have the great problem of a potential disintegration of the euro.” The apparent cohesion of European governments' approach to the crisis, the belief that Greece could avoid a restructuring, and the confidence in the euro of the man who is arguably the world's central senior banker were all swept away—even after a

trillion-dollar headline rescue package had been procured with great fanfare just four days before.

## What Next?

While it is indeed true that no man—or nation—is an island, especially not in a world of highly integrated financial markets, it is important to be clear that the southern European crisis was not inevitable. It sprang mainly from the failure to implement the fiscal discipline required of nations that participate in a single currency area, especially nations with widely divergent rates of productivity growth and limited labor mobility among them.

The crisis was exacerbated by the ECB's initial refusal on May 6 to purchase the questionable southern European sovereign debt directly while decisions were made about whether to restructure some southern European sovereign debt and, over a longer period of time, to reimpose fiscal discipline on all EMU members. The crisis makes clear that countries that cannot demonstrate a credible return to fiscal discipline should not be part of the EMU, since a lack of fiscal discipline in some countries compromises the credibility of the euro as a viable store of value.

Given the prominent dissents on the ECB governing board with respect to the initiation of purchases of southern European government debt, it may take some time for the ECB to reach the conclusion, as the Fed did in March 2009, that a substantial expansion of its balance sheet to include some low-quality assets will be required to exit the crisis environment. Recall that the Fed's substantial balance-sheet expansion came about six months after the Lehman Brothers crisis and a little over five months after the Troubled Assets Relief Program was announced, a period that witnessed substantial market volatility and a continued sell-off of risk assets.

The EMU and the ECB do not have five months to articulate a coherent approach to the sovereign debt crisis in southern Europe. If they take that long, it will become more clear every day that indeed “no man is an island” as the global financial system is put increasingly at risk by the severe erosion of capital in European banks.