

The Euro Crisis and Austerity: The Road to a Lost Decade

By Brian Fabbri (July 2012)

On its present path the European Union's economic crisis will eventually devolve into a political crisis. Ironically, it is the mirror image of the union's founding idea of creating a political union through economic integration. The EU's founding fathers' idea in the years immediately following WWII was to create an economic tie between France and Germany that would eventually grow to bind them sufficiently to reduce any future threat of war. It began with the Treaty of Paris in 1951 that established the European Coal and Steel Community. Its founding members were Belgium, France, Germany, Luxemburg, Italy, and Netherlands.

The next major step toward eventual union was the *Treaty of Rome* which in 1957 created the European Economic Community. It authorized free movement within the 6 countries, and created common trade customs and agriculture policy. In 1967 the European Community (EC) was established. Then in 1973 Denmark, Ireland and the UK joined the EC. In 1981 Greece joins and in 1986 Spain and Portugal join. The Maastricht Treaty was settled in 1991, which formed the European Union (EU) and established common foreign and security policy. It also set up a series of fiscal policy rules to supposedly fix the fiscal fissure that would eventually cause the present crisis. The EU leaders stopped well short of fiscal union (tying together their national budget policies under one pan EU bureaucratic union) when they created the Maastricht Treaty. Instead, they left fiscal policy to democratically chosen national leaders and this choice eventually became the critical fissure in the EU monetary and currency union. Finally, in 2002 the Euro was circulated and it became the common currency for 17 member countries. Unfortunately, all of the EU members subsequently ignored and abused the Maastricht Treaty's covenants. Germany was first to abuse the Maastricht Treaty budget rules and thus they set the precedent, which ultimately heralded the EU's present dilemma. Nevertheless, because the European nations' political goal remains undiminished, it will cause all members to fuse together in spite of their present economic difficulties.

Credit Is at the Bottom of the Crisis

Currently the Eurozone manifests itself to be an economic zone with a few healthy economies and the rest bordering upon default and depression. Credit is at the bottom of this dilemma; too much in the golden years of the past decade, and too little in the past four years. Easy access to cheap, abundant credit fueled housing booms across

Europe in the 1990's and the first few years of the present century. It also accelerated consumer spending well above its traditional role. Now credit is less available, although relatively cheap for some. But consumers aren't borrowing as they did in the past and banks are far more credit conscious. Consumers are slowly working down their debt to income ratios to more manageable levels. This household deleveraging is causing the inevitable slowdown in GDP growth everywhere in Western economies.

Households weren't the only flagrant abusers of easy credit. Governments were equally guilty. This is the sad plight of many southern European countries. Their cost of credit has exploded, and the availability of new credit is scarce. Moreover, they are facing repayment problems. At their present nominal economic growth rates and soaring sovereign interest rates, most of these southern European countries are headed for insolvency.

Lethal Fiscal Arithmetic

European countries are suffering from dangerously weak fiscal arithmetic and an undercapitalized banking system. First, these indebted countries are agonizing with anemic or non-existent real economic growth. Second, in this fragile economic environment the rich countries are imposing economic austerity measures on the credit starved countries in exchange for more credit so that they can repay their existing debt. These austerity measures will trap the debt-encumbered countries into longer periods of below normal economic growth. Since present interest costs are well above their expected nominal economic growth rates, these economies are becoming trapped in a dangerous downward spiral. For countries whose sovereign debt levels equal or exceed their nominal GDP, the financial trap of higher interest cost is lethal. Indebtedness and debt service will grow faster than their ability to repay. Third, as second class economies, they will forever be begging for another credit fix unless they default and start over. More EU credit will only add to the sovereign fiscal debt to GDP ratios and increase the severity of the debt trap. Fourth, the threat of default will encourage capital flight and precipitate a run on the banks of suspected countries. It is already happening in Greece. Smart money from wealthy individuals has been quietly withdrawn and in the latest month, 700 million euro deposits have been drawn down. A Greek default and run on its banks will quickly spread to other threatened countries as citizens will ask 'who is next?'

EU Banks are in Trouble

Default may relieve individual countries' credit problems, but it will leave the credit holders, mainly northern Europe banks, with huge losses and a costly need to generate

more equity capital. Such losses will also severely limit their ability and desire to lend new funds to needy businesses thus thwarting potential new sources of economic growth. This will add to the severity of the ongoing dangerous downward economic spiral.

European banks face a massive capital shortage. At the beginning of 2012, the European Banking Authority optimistically estimated that banks needed 115 billion Euros in Tier One funds. More light is presently being shed on this woefully low estimate as 100 billion euros was lent to Spain in June to shore up their beleaguered banks. The EU banks are under stress because of their large holdings of European sovereign debt that has declined significantly in value over the past three years. In addition, the creditworthiness of their loan portfolio has similarly deteriorated substantially as many corporate borrowers are trapped in growth-less economies. Europe's banks need to be saved in order for the EU economy to expand. First, the banks must be recapitalized with fresh equity perhaps supplied by the European Financial Stability Fund, or its successors. And second, a pan EU deposit insurance scheme should be implemented to insure against future runs on banks.

The ECB's Christmas gift to the banks of 489 billion euro in low-cost (1%), 3-year funds was not sufficient to solve all of Europe's economic problems. It is true that banks could use these funds to buy high-yielding Spanish and Italian bonds, which presently yield an unsustainably high 7% and 6.20%, respectively, and hence earn a profitable spread and provide funds to debt-starved governments. However, this will not solve the economic problems in those countries. Moreover, buying more sovereign bonds will increase the banks' risk portfolio as these sovereign bonds have had capital losses this year. As a result, sovereign bond-stuffed banks are in the same default position as their government, which prevents them from expanding their risky asset portfolios.

European leaders are obliged to stimulate economic growth, not burden it with austerity packages. Europe slipped into recession in the 4th quarter of 2011 and is forecast to remain in recession through this year at least. Weak economic growth and sovereign credit deterioration are a prescription for a weak Euro in the months ahead. A weaker currency should boost exports latter in the year. Monetary policy should be conducted with an easier tone under new chairman Mario Draghi than under his predecessor. Further rate cuts – 50 basis points should be the minimum - and the introduction of quantitative easing should induce some positive response to economic growth. But, monetary policy alone will not be sufficient to pull the entire EU out of recession. For the Euro area to remain intact the richer northern countries will have to transfer massively more cash without austerity commitments to the debtor countries of the south. Moreover, sharing of sovereignty over fiscal issues and convergence of

competitiveness will be necessary over time to keep the Euro entity alive. EU leaders will have to attain the political 'buy in' from their respective constituencies to achieve such federal integration. It won't be easy or quick and will require considerable patience and persuasive rhetoric. The EU leaders should also learn from the fiscal policy mistakes made by past elected officials in Japan and the US, which condemned their respective countries to endure a decade of lost economic growth.

Lost Decades

The Japanese lost decade was in the 1990's: although some might say it is still ongoing and therefore its memories are still fresh. Their lost decade has been analyzed and the mistakes made have been glaringly publicized by many esteemed economists include Federal Reserve Chairman, Ben Bernanke. Perhaps most relevant to the present EU situation is the Japanese government's rash decision to raise the consumption tax in 1997 inopportunately, just when the first shoots of economic growth appeared. It knocked their economy back into recession for the next several years. America's lost decade came 90 years ago at the end of the roaring 1920's. The great depression lasted through the 1930's and ended when WWII brought about a demand-led recovery in production. Unlike the Japanese economic demise, the US depression of the 1930's coincided with a global economic meltdown.

Lessons from the US Depression

The economic devastation in the US was heralded by the catastrophic crash in the stock market in October 1929. The stock market wouldn't regain its 1929 peak until 1954. One month later an estimated \$30 billion in stock value was lost. Ultimately the stock market fell almost 90% and wiped out \$25 billion of the nation's wealth, or \$350 billion in present dollars. Six months after the crash the number of unemployed workers more than doubled. By 1933 the unemployment rate rose to 25% and it soared to over 37% for non-farm workers. US GDP fell 30% and industrial production plunged 45%. Over 60% of Americans were classified as poor and the average family income had been reduced by 40%. At the time the US president, Herbert Hoover, asserted that the worst effects from the crash were over. Fifteen months after the crash The President rallied his party's congressional members against a 'bonus for veterans of WWI' saying that 'payment of these funds would cost the Treasury \$4 billion'. As a result, the US federal budget remained in surplus through the first four years of the Great Depression. This misguided policy thinking helped perpetuate the depression to last another 8 years.

A new government was overwhelmingly voted in 1932. In the immediate years following the stock market crash, the new government enacted several important

financial regulatory measures. The Securities Exchange Commission (SEC) was established, and the Glass-Steagall Act was legislated, which separated commercial and investment banking activities. And in 1933 the Federal Deposit Insurance Corporation (FDIC) was created to insure individual bank deposits. While these critically important regulatory acts were necessary to re-establish confidence in the US financial system, they did nothing to improve the condition of the economy.

As massive unemployment persisted, protests broke out throughout the US, many protesters were killed, some by the government and some by private corporate hired guards. Xenophobic slogans were shouted and local ordinances were legislated against jobs for foreigners. A Mexican Repatriation program was started, and **more people emigrated than immigrated to the US**. Banks started to fail. By 1933, over 40% of banks in the US had failed. The Reconstruction Finance Corporation was established by congress to lend \$2 billion to banks and insurance companies. The frustrated public in their confusion viewed this act as 'a millionaire's dole'. Many of these measures of economic distress from the 1930's are frighteningly similar to labor market conditions in modern-day Spain. And the voices from the US past are echoing loudly in the present day public resentment of the loans granted to Greece and other countries.

The new government finally began to legislate a series of fiscal policy initiatives starting in April 1933, three and a half years after the stock market crash. First, the Emergency Banking Act was signed. It took the US off the gold standard. Then the Civilian Conservation Corps was created, which employed young men to work in national parks. By May of 1933 the national Industrial Recovery Act was passed, it gave the administration the right to set price and wage controls. Then the Tennessee Valley Authority was formed. It built dams and produced fertilizer. In October 1933 the Civil Works Administration was established. It became heavily funded only late in 1934 and was designed to build large infrastructure projects throughout the country. It was complemented by the introduction of the Works Progress Administration one year later which employed workers and artists to improve the nation's infrastructure. In spite of these mild fiscal stimulatory measures the economy continued to stagnate and unemployment remained high. The President conscious of labor's needs, set up the National Labor Relations Board, which encouraged the expansion of labor unions. In addition, Social Security was rolled out. Neither of these initiatives created new economic activity. Unfortunately this set of tepid fiscal responses was much too timid to ignite sustainable economic growth and employment.

In 1937 a nascent economic recovery stumbled and unemployment soared again after the Federal Reserve made a shockingly wrong decision to double reserve requirements. Their inappropriate decision naturally led to a contraction of the money supply.

Complementing this disastrous policy mistake was the negative impact from the federal budget. Total federal spending peaked in 1936 and subsequently declined over the next 2 years. As a result, the national budget deficit plunged and created 3 percentage points of fiscal drag on the economy in 1938.

Finally, in April of 1938, eight and a half years later, as the economy slumped further because of inappropriate monetary and fiscal policies, the President asked the US Congress to authorize \$3.75 billion of additional fiscal spending to stimulate the economy. It was ultimately raised to \$5 billion in 1939, or approximately 5% of GDP. At its peak during the depression total federal budget spending rose to 11% of GDP, less than half of its current level. It wasn't until 1941, after the US entered WWII, that the economy finally emerged from the great depression buoyed by the demands of war and supported by unlimited fiscal spending.

Social Unrest is Coming

The destabilizing buildup of debt by nearly all EU members has created a dilemma for the EU's leaders and institutions. The present EU leaders have unfortunately ignored the history of lost decades suffered by the US and Japan. The present solution orchestrated by hard core EU members, Germany and its northern neighbors, and presented to mainly southern member countries to patch over their present debt dilemma is a combination of minor debt forgiveness, and more loans. The loans have been granted at the exorbitant cost of accepting stringent domestic austerity. The countries in debt trouble were already in, or nearly in, a cyclical economic decline and newly imposed fiscal austerity measures will only hasten and deepen their decline into a deeper recession. Recession and its attendant rise in unemployment will eventually lead these distressed countries into social unrest. Social unrest will initially lead to socialism.

As unemployment mounts and political alternatives vanish, the public will rebel at first shouting inconsistent and contradictory slogans and messages, and later more violent protest similar to the events in the 1930's in the US. The social pain will feel even more acute because the sources of the austerity measures, which have been forced upon elected officials, are from foreign countries. The beleaguered masses are beginning to believe their elected officials are not strong enough to resist external pressures, or clever enough to advocate an alternative approach. Consequently, mass rallies against the present governments, especially if they are conservatively-oriented, and their austerity policies will arise as countries head down the path toward anarchy.

Before revolution occurs, the masses have one final hope: another government regime. One that is new with fresh ideas or at least one that is economically growth-oriented. Economically distressed and unemployed citizens require reassurance, safety, consistent policies and stability, not opportunities to maximize after-tax profits. In reaction to the stock market crash and soaring unemployment in the US, a socialist-leaning President and US Congress was elected, and they presided over American politics for 20 years. And another 30 years would pass before the US elected a free market Republican regime. In France, the political solution was to elect a socialist government that espouses economic growth over austerity. Certainly other countries will follow this example. The new French government is also a less friendly one to business, one that rejects many of the free-market principles that the former conservative governments advocated, and one that considers the financial markets its main enemy. It remains to be seen if this political shift toward socialist parties will produce sufficient results, or if more radical solutions will be required. In the US, a socialist president could not produce a strong enough agenda to end the great depression. It is obvious that the political pendulum in Europe has begun to swing firmly to the left, and quite quickly. Europe is set to reject in whole or in part its version of the free market paradigm that dominated economic and political thinking for the past two decades.

The End of the Free Market Paradigm?

The free market paradigm was on the rise before the Berlin Wall collapsed, but it really lifted off after the Soviet system crumbled. Every country throughout the world either embraced capitalism with its free market regime, or modified their present regime with greater free market accountability. Capitalism reached its recent pinnacle in the years leading up to the great recession of 2008-09. It was the hubris acquired during years of success that led capitalist governments to rely on lax regulation over the ultimately corruptive forces of free markets. This laissez-faire behavior led to the economic excesses of the last decade, and the inevitable economic downfall in 2008. Now several years later, Western governments are trying to manage their debilitated economies with the conviction that free markets will revive economic growth without their help. The trust in the old remedies of federal budget restraint, personal credit repayment, and the magical rhetoric of structural reform is itself a critical part of the present economic travail that EU governments find themselves. If the current politicians cannot change course and apply new fiscal solutions then new politicians will replace them. Either way, it looks as though the EU is on course for a lost decade.



Dr Brian Fabbri is Managing Director of FABBRI Global Economics. He was formerly the Chief U.S. Economist for North America at BNP Paribas, and was based in New York. Dr Fabbri also worked as senior vice president, chief economist and director of institutional research at Thomson McKinnon, as vice president & senior economist at Salomon Brothers, and as head of the capital markets unit at the Federal Reserve Bank of New York. He appears regularly on CNBC and other business networks and radio shows, and is a member of the National Association of Business Economists, the New York Association of Business Economists, the Downtown Economists Club and the Money Marketers. Dr Fabbri earned a Ph.D. at New York University.

For more information, please contact camri@nus.edu.sg