Five Big Myths About the European Debt Crisis

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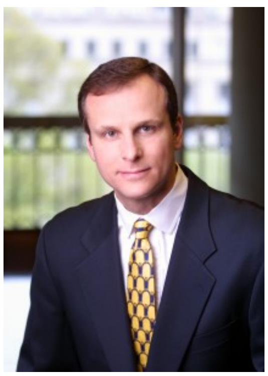

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Europe consumed more than a fifth of America's exports last year, yet U.S. markets seem to be ignoring Europe's current economic turmoil. Much of Europe is heading into a recession, Euro-zone unemployment is at record highs, and Europe's largest banks are struggling. With European governments imposing austerity budgets, a looming credit squeeze, and many countries facing shrinking tax revenues and overwhelming debt burdens, it is hard to see when growth will return. To understand how Europe poses a risk to the U.S. economy, it is important to dispose of some of the myths that surround Europe's debt crisis.

1. Germans are more fiscally responsible.

To ensure fiscal discipline, the Maastricht Treaty restricts the amount of public debt that countries in the European Union can assume to 60% of their gross domestic product. Yet Germany has violated this limit every year since 2003. That has not stopped German politicians from bragging about German fiscal discipline. A few months ago Bavaria's Christian Social Union party, a key member of German Chancellor Angela Merkel's governing coalition, almost derailed Germany's contribution to a European bailout fund because Bavarians do not abide debt. "We are not prepared to accept zero debt here and total debt elsewhere," declared CSU party leader Horst Seehofer, to a standing ovation.

But three years earlier the Free State of Bavaria secretly took a $2.4 billion bailout from the U.S. Federal Reserve, and a 94% Bavarian government-owned bank, Bayerische Landesbank, took another $10 billion secret bailout from the Fed, according to data uncovered by *Bloomberg News*. In fact, many other German and European banks secretly received $500 billion in secret bailouts from U.S. taxpayers during the same period, according to *Bloomberg*, all on top of the $50 billion they got from the U.S. government's TARP bailout of AIG.

American bailouts of European (including German) banks continue. The Fed is quietly extending currency swap lines via the European Central Bank, thereby funneling billions of more U.S. dollars to European banks whose identities remain undisclosed thanks to ECB privacy rules. The ECB has also increased its own bailouts for 523 banks to €489 billion ($640 billion), in the form of three-year, 1%-interest loans.

2. The European Union respects democracy.

Because so many Europeans feared that larger countries would dominate the EU, the Treaty on European Union promised more than half a billion people that "every citizen shall have the right to participate in the democratic life of the Union," that "decisions shall be taken as openly and as closely as possible to the citizen," and that the "functioning of the Union shall be founded on representative democracy."

Despite that, Germany proposed that Greece's receipt of a second bailout be conditioned on Greece surrendering its tax and spending sovereignty to a Euro-commissioner. Greece's revenues were "to be used first and foremost for debt service," and "only any remaining revenue may be used to finance" government activities, such as national defense or the judicial system. And in place of decisions made by democratically elected leaders, the Euro-commissioner would have "a veto right against budget decisions not in line with the set budgetary targets and the rule giving priority to debt service."

Germany backed down after France and other countries objected, but the assault on democracy and self-determination in the EU is not dead. In December, European Council President Herman Van Rompuy secretly proposed that EU countries that did not meet strict fiscal rules should be subjected to "intrusive control of national budgetary policies by the EU" as well as "political sanctions such as the temporary suspension of voting rights." And of course both Greece and Italy voluntarily surrendered their governments to unelected ECB "technocrats," because their embattled political parties had lost credibility with other European governments as well as their own citizens.

3. The PIGS have only themselves to blame for Europe's woes.

Northern Europeans have long told how Portugal, Italy, Greece, Spain, and Ireland, the peripheral or "PIGS" countries, caused the Euro-crisis by some combination of corruption, tax evasion, over-regulation, state-protected sectors, political dysfunction, incompetence, and market speculation.

All true, but not the whole truth. More than a third of Germany's GDP derives from exports (the most of any country in the world), with 60% of those exports going to its European neighbors. Germany's mercantilist economy relies on these countries' purchases of German goods. With their sovereign debt denominated in Euros and backed by the Euro-zone's overall credit, Greece, Portugal, and others were able to borrow at interest rates far below what their own GDPs would have allowed. With this cheap money and the worldwide credit surplus of the past decade, peripheral governments and citizens were able to gorge on imported Northern European goods.

While countries like Greece and Italy were using derivatives to cook their books when borrowing, European and American financial institutions were helping them do it. Moreover, because they share the Euro, peripheral countries cannot devalue their currencies in order to make the cost of their goods and services more cost competitive. And when the EU expanded eastward, foreign direct investment that had been flowing south shifted east, depriving peripheral countries of investment capital that would have demanded political and economic reforms.

4. Northern Europe is bailing out the South.

For weeks, Greece has been negotiating with a creditors' committee of more than 450 financial institutions, joined by a troika of the International Monetary Fund, the European Central Bank, and the European Commission, to deal with €205 billion ($269 billion) of publicly-held Greek sovereign debt—with a €14.5 billion ($19.1 billion) bond payment due March 20. In connection with an expected write-down of 50% or more of Greek debt and rescheduling of the remainder at around 3.5% interest, the troika is holding out the prospect of a second "bailout" of as much as €130 billion ($171 billion) in loans.

This package, on top of the €110 billion ($144 billion) in May 2010, is again being advertised by Northern European politicians as a second Greek bailout. And to sell it to German voters, Chancellor Merkel is demanding recessionary "austerity measures" from Greece. But the North is also bailing out its own banks and customers as well as the ECB, which wants to avoid principal losses on its €55 billion ($72 billion) Greek bond holdings.

In fact, most of the bailout funds may never reach Greece, and instead may go to an escrow fund that will pay off German, French, and other banks directly. French banks hold about €43.5 billion ($57 billion) in Greek debt, followed by German banks with about €18.2 billion ($23.8 billion.) Although these and other private bondholders may take a "haircut" of 50% or more, a bailout will at least avoid the prospect of a total default. And with the EU experiencing around 10% unemployment and on the brink of recession, it is vital that the peripheral countries have access to public and private credit to keep buying northern goods. The best way to avoid a credit squeeze is a Greek rescue package that rescues Europe's banks.

5. Europe will avert a crisis after a Greek bailout and debt restructuring.

European markets appear optimistic that the debt crisis in Greece and elsewhere will be contained: Bond yields have been lower over the past few weeks and the Euro Stoxx 50 volatility index hit a five-month low last Friday.

But if Greece averts a default short-term, that will not ensure that Greece remains afloat. The International Monetary Fund predicts that that even if Greece meets all of the troika's austerity demands, its debt-to-GDP ratio will be 135% by 2020, meaning that Greece has no prospect of borrowing at market rates for the foreseeable future. The Economist Intelligence Unit estimates that the Greek economy, which has already endured five years of recession, will shrink an additional 7% this year following last year's more than 6% drop. Unemployment in Greece is at 21% and rising; government services are crumbling; and the 12 largest Greek banks will probably need a government takeover. Meanwhile Spain, which is experiencing 22.9% unemployment, estimates that its economy will shrink 1.5% this year, exacerbating its budget deficit. Portugal's economy will shrink by 5% and may have difficulty refinancing its debt. Italy's debt-to-GDP is 119%, and some believe that Hungary may default on its debt before year's end.

The only help on the horizon is the possibility of the ECB's lowering the discount rate further and the hope of a second, €500 billion ($655 billion) Euro-wide bailout fund. But Europe's banks are undercapitalized and are parking record amounts with the ECB instead of lending. And even if European countries and companies can refinance their debts, liquidity will not solve the Euro-zone's structural problems and chronic trade imbalances. Until Europe finds a solution, the crisis will continue.

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