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How Europe's elites turned PIGS into a full-bore financial disaster

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:U heavyweights French President Nicolas Sarkozy and German Chancellor Angela Merkel. Picture: AFP
'ource: AFP

WHY is Europe in crisis? To fund budget deficits over the period 2011-13 and repay existing loans, Portugal, Ireland, Greece and Spain (the "PIGS") require external financing equal to 50 per cent of their combined 2010 gross domestic product.

Financial markets do not believe that financing will be available on terms those countries, particularly Greece and Portugal, can afford.

They therefore perceive a high risk of default, which increases risk premiums and pushes up the PIGS' borrowing costs, aggravating budget deficits (as it raises the cost of servicing public debt) and making default even more likely.

But default would impose large losses on eurozone banks that hold PIGS' debt and undermine the eurozone's viability. And even if default is avoided, the debt-burdened PIGS are headed for prolonged recession, fuelling tensions within the EU and making sustained growth less likely.

Is this the first time these countries got into trouble? Hardly. The drachma (meaning "handful") for example is one of the world's oldest currencies. But since the reintroduction of the drachma in 1832, Greece has spent more time in default on its loans than any other European country, including Russia.

Why does the pattern of incurring massive debts and running into trouble recur? It reflects social conflicts that are especially pronounced in southern Europe, which for many years had fascist regimes and only quite recently made the transition to democracy.

Those conflicts make it difficult to levy taxes, while creating pressures to rely on public expenditure to paper over the social cracks. They therefore lead the PIGS to spend more than they earn, precipitating periodic crises that bring growth to a crashing halt.

How did they get into trouble this time? The PIGS joined the euro at a time of relatively low inflation. This was reflected in low interest rates, including those set by the new European Central Bank.

But monetary settings that were sensible for Frankfurt were completely inappropriate for Athens. Inflation was significantly higher in the PIGS than in northern Europe, so the ECB's policies made real interest rates (the nominal interest rate minus the expected inflation rate) in the PIGS zero or even negative.

Those low rates reduced the cost of debt and made new borrowing very attractive.

What form did the response take? This depended on each country's financial development.

Spain, for example, has a sophisticated banking sector. Faced with zero real interest rates, Spain's banks expanded their loans to households and businesses, unleashing a property boom. Spanish property prices more or less doubled and by 2006, when its inflation rate was the highest in Europe, Spain's building spree was consuming half of Europe's cement.

By contrast, financial markets are far less developed in Greece and Portugal, so voters elected governments committed to borrowing on their behalf and expanding the public sector.

Unsurprisingly, by 2008 Greek public debt amounted to 100 per cent of GDP.

Where did the money come from? While the PIGS were on a borrowing binge, northern Europe was in the midst of a fiscal consolidation. This was especially true of Germany, which was working off debts incurred in its reunification. Together with wide-ranging wage restraint, that fiscal consolidation resulted in low inflation and declining unit labour costs.

So while prices in Spain rose from 2000 to 2007 by 8 per cent more than in the eurozone as a whole, in Germany they rose by 4 per cent less.

Given low inflation, real interest rates in northern Europe were relatively high, encouraging households to save.

Along with reduced budget deficits, this meant northern Europe spent less than it earned, while the PIGS did the opposite.

How did the imbalances play themselves out? Declining unit labour costs made goods from northern

Europe very competitive compared with those from the PIGS, where debt-fuelled growth was pushing up producers' costs. In real terms, Germany devalued (its exports became cheaper) while the PIGS revalued (PIGS goods became more expensive).

The result was large current account imbalances, as the PIGS increased their imports. From 2000 to 2007, Portugal racked up a cumulative trade deficit of 71 per cent of GDP, Greece of 67 per cent and Spain of 46 per cent. Germany, by contrast, accumulated a cumulative surplus of 26 per cent of GDP, while its exports to Greece increased by 130 per cent.

The EU hailed growing intra-EU trade as a triumph of European integration. In fact, it was a disaster waiting to happen as the corresponding deficits were financed by loans from northern European lenders to commercial borrowers and governments in the PIGS.

By 2010, the exposure to the PIGS by lenders in Germany, Britain and France was around $1.2 trillion. And like the Asian economies in the 1990s the PIGS, committed to servicing large loans in a currency they did not control, were now vulnerable to collapse when the inflows suddenly stopped and then reversed.

Where were the regulators? Rather than restraining the process, Europe's politically correct regulators were encouraging it. For instance, European banks were required to treat all euro-denominated public debt as having equal default risk for the purposes of prudential requirements. This made it highly profitable for European banks to replace low-yielding German debt with far higher yielding PIGS debt.

What happens next? With so much at stake the EU, helped by the International Monetary Fund, will bail the PIGS out, courtesy of European taxpayers. The PIGS will undertake reforms but will not address the root causes of their periodic crises. And with slow growth ahead for southern Europe, and a fragile, unpopular euro, tensions within the EU will become ever more acute.

Lessons? Here's one. Much like Europe's emissions trading scheme, the euro was a "solution" imposed by Europe's political elites. For the French, it would challenge the despised US dollar; for the Germans, it would buy French acceptance of reunification and a more assertive Germany; and for southern Europe's socialists, it promised to painlessly transform Sicily into Switzerland. All this proved no more than magical thinking. But because bad policies are easier to introduce than to remove, its costs will be there for years to come.

What can prevent such poorly conceived ideas from getting up? Robust, even divisive, public debate. No wonder elites hate it. No wonder it played no role in the decision to adopt the euro. And no wonder Ross Garnaut says arguing about a carbon tax makes us look foolish compared with how they do things in Europe.

Well, if that is foolishness, long may it continue.