Sliding in Greece? The recent turmoil in Greece reflects a much broader set of problems with possible global financial consequences. Greece, which is a member of the Euro-currency zone, has had trouble issuing “sovereign” (national government) debt. Riots and strikes have occurred as workers protest government austerity measures enacted to reduce budget deficits. There are concerns that other nations have similar difficulties.

The great Euro currency experiment is unlikely to be abandoned. However, Europe has to make important changes to a system that is now more than a decade old. Furthermore, the debt financing problems of nations like Greece could spread to many parts of the world and cause financial distress just when the global economy seems to be recovering from the last financial crisis. Even if we manage to avoid contagion, resolution of what are becoming widespread debt problems could hobble economic growth for years to come.

EUrology: A little more than ten years ago, 12 European economies abandoned their own national monetary systems to adopt a common currency, the Euro, and a single monetary policy under the European Central Bank (ECB). Britain, Sweden and Switzerland chose not to participate. The list of members has since expanded to include, among others, Greece and Portugal.

Ever since World War II, Europe has been moving towards greater economic cooperation and integration. It started with lower tariffs under the Coal and Steel Community, expanded with the Common Market and culminated in the European Monetary Union of 1999.

United States of Europe? I’m still amazed that the voters of the participating nations approved the monetary union. Ratification amounted to surrendering major aspects of national economic sovereignty in order to become much more like one of the 50 American states. No longer do Italy, France, Germany et al have the authority to set their own interest rates and exchanges rates. In addition, they gave up considerable control over their fiscal (budget) policy by agreeing to limits on the size of their deficits.

However, unlike the United States there are no mechanisms in place for national economic stabilizers such as federal tax cuts and extended unemployment benefits to help during downturns. And there are major restrictions on the kinds and amounts of monetary and fiscal aid that can be given to financial institutions and member nations.

For years, I’ve wondered whether European voters fully understood what they were buying into. Perhaps many felt that they were simply swapping their own individual currencies for the Euro. This certainly has conveniences, especially for trade and travel across national borders.

How well has it worked? Until several years ago, the main criticism was that the ECB’s monetary policy may have been too tight as interest rates reduced GDP growth in order to keep inflation in check. Much of Europe had significantly higher unemployment rates than the United States. In making monetary policy, the ECB took the position that this reflected “structural” conditions and, as such, was not curable through lower interest rates. The Euro countries managed to survive the financial crisis of the past two years – the first real stress test of the system.

The recent sovereign debt problems, which surfaced towards the very end of last year, are concentrated in a handful of countries: Portugal, Ireland, Italy, Greece and Spain, also known as the PIIGS in the financial press. The difficulties are the result of both fiscal laxity and global recession, with the proportions of blame varying across countries.

Interestingly, the early successes of the EMU may have helped precipitate the current crisis. Countries with chronic budget deficits, such as Italy, benefitted early on from a “convergence” of interest rates towards levels enjoyed by fiscally conservative Germany. Bond investors throughout the world felt that the EMU budget requirements would force the formerly prodigal nations to reform. However, convergence had the opposite effect since it gave countries like Italy a free ride in the form of lower interest rates without budget reform... plenty of financial gain with little fiscal pain.

Musings & Amusings: Neologisms (Washington Post)

Coffee (n.), the person upon whom one coughs
Flabbergasted (adj.), appalled over how much weight you’ve gained
Abdicate (v.), to give up all hope of ever having a flat stomach
What’s next? Budget tightening might have been much easier to accomplish a few years back when the economies were all growing reasonably well. Today’s very high unemployment rates make it very difficult politically to cut government spending. And, of course, membership in the EMU means that countries can’t devalue the foreign exchange value of their currencies or reduce their interest rates to offset the economic effects of budget tightening.

Greece needs to borrow to cover its budget deficit. And as long as bond investors and speculators believe there’s some chance that the wealthier nations such as Germany won’t bail them out, then Greek bonds will come under attack. This has caused interest rates on Greek national bonds to rise dramatically relative to Germany’s. Greek bond yields have recently been almost double those of Germany. Within Euroland, interest rates have remained quite low for Germany and France. They’re a bit higher in Ireland, but have been receding since the Irish began to take major steps to reduce their budget deficit.

Importantly the Euro currency has weakened as investors prefer the safety and security of U.S. financial markets! In early March, a Euro cost $1.36 – down from $1.47 just three months ago. This is good for European businesses that compete with U.S. firms on the Continent and in export markets. While this shift is not beneficial to U.S. businesses that export or compete with imports from the Euro-zone, it does help travelers from the United States when they visit Europe.

Where do we go from here? The final compromise will be painful. Greece – and the other problem countries – will have to tighten budgets dramatically, in the face of high unemployment. Among other measures, this means cutting pension benefits and wages for public employees. Germany will have to provide some form of funding or bond guarantees – even though it will gall those serious Teutonic types to subsidize those fun loving ouzo drinkers who smash plates while dancing to bouzouki music during their early retirements!

I doubt very much that a national default within the EMU can be tolerated because it would quickly cascade around the world, with nation after nation falling to the speculators. Even if a Greek default could somehow be contained, it would do considerable damage to the banks in Spain, Germany and elsewhere that hold Greek bonds.

The reluctance of the Germans to rush to the rescue of Greece reflects sentiments being felt elsewhere, including the United States. There’s widespread concern over “moral hazard” where bailouts reward and encourage risky or extravagant behavior. Worries are also growing over the enormous amounts of national debt being issued as countries large and small run mind-boggling fiscal deficits. Much the same debate would take place in the United States if the budget problems of California or New York required federal assistance. There’s growing concern among economists that the process of reducing budget deficits in Athens, Sacramento and Washington, D.C. will lead to slow economic growth as governments are forced to raise taxes and reduce spending on infrastructure.

Some have suggested that the debt problem will lead to the breakup of the EMU. Turning back the clock ten years is not only highly unlikely, it is close to impossible. There are no provisions for dissolution or secession in the EMU agreements. Furthermore, Italy, Greece and other secessionist nations would be subject to violent financial turmoil if they withdrew from or were tossed out of the EMU. Their new currencies would plummet and their interest rates would soar. Global panic would ensue.

However, the EMU will need to change. Before they can be admitted to the union, prospective new members will have to prove that they are capable of meeting the budget requirements. Greece was less than forthright in this regard and had managed to hide much of its fiscal problem as it entered the EMU... a sort of economic Trojan horse? Like it or not, there have to be mechanisms for coordinated fiscal measures to fight both recession and overheating. That’s because “one size fits all” interest rate and exchange rate policies are not appropriate for every circumstance.

There also has to be a much more aggressive adoption of “structural reforms”. One reason why a single currency works so well in the United States is because labor and other resources are so mobile. This is not the case in Europe where customs and unemployment benefits keep people from moving to where the jobs are.

As Rosanne Rosannadanna used to say years ago on Saturday Night Live, “Well, Jane, it just goes to show you, it’s always something.”