Joint Economic Committee
Republicans
Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Euro Crisis and America #1

The Euro's False Premises for Sustainable Economic Growth:
A Warning to the U.S. from Greece and Spain

May 27, 2010

The Euro-Zone

For several years after introduction of the euro in 1999, European Union (EU) Member-States in the euro-zone experienced rising prosperity.[i] Commentators hailed the euro as a success in terms of (1) becoming a world reserve currency, and (2) accelerating economic growth in countries that adopted it. The euro's exchange value relative to the U.S. dollar rose for a number of years. Commentators speculated about the euro replacing the U.S. dollar as the primary world reserve currency and commodity exporters quoting their prices in euros instead of U.S. dollars.

Government spending as a share of GDP is higher in almost all EU Member-States than in the United States. EU Member-States have more generous old-age pensions, unemployment benefits, and social-welfare benefits, including socialized health care. EU Member-States also have more restrictive labor laws and a larger share of their labor force is unionized. Government influence over the energy sector is greater in the EU than in the United States. Many Member-States penalize fossil fuels through high excise taxes and subsidize alternative sources of "clean" energy. Prior to the euro crisis, some policymakers thought the euro-zone had "evolved" past the United States into a well functioning, "green," and compassionate economy that offered a smooth path to prosperity for its citizens.

As it turns out, however, some EU Member-States on the Atlantic and Mediterranean fringe, especially Greece, Spain, Portugal, and Ireland, benefitted from large external borrowing at low interest

- The euro-zone seemed like a magic carpet for a time, lifting up developing economies. It turns out they were lifted by a bubble of debt.
- It is evident today that Europe has not found a substitute for increases in productivity, flexibility, and competitiveness to drive sustained economic growth.
- Government overspending in Greece created the illusion of more prosperity with less work, but in reality created a mountain of unserviceable debt obligations.
- Spain's government inflated a "green" bubble that burst, prompting *The Wall Street Journal* to observe "Spain's Solar Power Collapse Dims Subsidy Model (Sept. 8, 2009)." Spain's unemployment rate now is 20%.

"Spain, Germany, and Japan … [are] surging ahead of us, poised to take the lead in these new [renewable energy] industries. … It's because their governments have harnessed their people's hard work and ingenuity with bold investments—investments that are paying off in good, high-wage jobs—jobs they won't lose to other countries."

--President Obama

costs after adopting the euro. In Greece, the borrowing was primarily by the Greek government. In Ireland, Portugal, and Spain, the borrowing was primarily by households and firms (although the world recession has increased government budget deficits in these Member-States as well). When lenders became reluctant to extend more credit, problems with the euro-zone and with some of its supposedly well-functioning economies quickly surfaced.

Financial and Currency Infirmities

The Greek debt crisis has radically altered much of the perception of the euro-zone in a very short time. Excessive government spending, budget deficits, and government debt accumulation have burst into the open and caught the euro-zone Member-States unprepared to resolve a sovereign debt crisis. Last year, the Greek government's estimate of its budget deficit jumped from 3.7% to nearly 13% of GDP. Eurostat, the statistical agency of the EU, now reports Greek government budget deficit-to-GDP and debt-to-GDP ratios of 13.6% and 115%, respectively, for 2009.

Government overspending is the cause. To cite just one example, Greek old-age pensions are among the most generous in the OECD: a new 20-year old employee who works until age 65 would receive a pension corresponding to 96% of his gross earnings compared with an average of 59% for the OECD.[ii]

The Greek debt crisis threatened the solvency of some European banks and ignited a scramble for an EU-IMF "bailout" to shield these banks from a Greek government default. This bailout ignores the euro's institutional framework and violates fundamental economic tenets set forth in the Maastricht Treaty of 1992.[iii] The ad hoc nature of the response leaves unclear what financial obligations EU Member-States have to each other and whether they will press the European Central Bank (ECB) to resolve sovereign debt repayment problems simply by monetizing the debt. No one is talking about replacing the U.S. dollar with the euro anymore.

Economic Fundamentals

But what of the fundamental economic policies that characterize the Member-States, did they facilitate a better growth path? On this question, it is instructive to consider Spain. With a population of 46 million and a €1 trillion economy, Spain is far larger than Greece and accounts for a significant part of euro-zone GDP. Spain did not do what Greece did. The Spanish government did not overspend and accumulate government debt. On the contrary, the Spanish government had budget surpluses for a number of years prior to 2008. Moreover, Spain's bank regulatory policies were among the soundest in the world. Spanish banks were well capitalized and better able to absorb the investment and loan losses from the global financial crisis and the resulting recession than many other banks. In other words, Spain was not part of the problem of fiscal and financial sector mismanagement that has captured most of the attention so far.

Nevertheless, Spain went from "the vanguard of a new wave of prosperous European economies"[iv] to posing a potentially greater risk to European economic stability than Greece does. Spain's annual GDP growth averaged over 3.6% from 2000 to 2007, but its economic competitiveness has been declining since 1998. Spain's current account balance declined from negative 1% of GDP in 1998 to negative 10% by 2007 as its relative labor cost rose by 13% and the relative wage cost in manufacturing rose by more than 18%.[v]

What went wrong?

The answer is cheap debt. The ECB must set monetary policy for the whole of the euro-zone even though economic conditions can vary widely among the Member-States. During most of the last decade, the ECB pursued a monetary policy consistent with price stability in the slowly growing Member-States of central Europe, especially France and Germany. However, the interest rates that were appropriate for one part of Europe were far too low for the more rapidly growing Member-States on the Atlantic and Mediterranean fringe. Free movement of goods and services within the EU largely prevented this overly accommodative monetary policy from bidding up the prices of tradable goods and services in these Member-States. Instead, price inflation occurred mainly in non-tradable local markets, particularly the real estate markets in Greece, Ireland, and Spain.

Admission to the euro-zone represented an economic stamp of approval. Most financial market participants believed the efficiency of dealing in a common currency and the economies of scale opened up by unencumbered trade in an expanded European market would pave the way for sustained economic growth. With euro-zone price stability supposedly anchored by the ECB, banks and other financial institutions were willing to lend freely at low interest rates to governments, firms, and households on Europe's Atlantic and Mediterranean fringe.

Thus, Spain, as other euro-zone entrants, obtained access to nearly boundless cheap credit before completing the hard work of making their economies more competitive. Spain has a rigid two-tier labor market in which permanent employees enjoy rich benefits and wages rise substantially in good times. During the last decade, cheap credit fueled a consumption binge, a construction boom, and price bubbles in both commercial and residential real estate. Rapid economic growth increased the demand for labor, especially in non-tradable sectors such as construction. Given the rigidity of the Spanish labor market, wages soared. The real cost of labor for Spanish firms rose as compensation growth outpaced productivity gains. As a result, Spanish firms in tradable sectors became less competitive internationally. Manufacturing's share of total Spanish employment fell from 18.6% in 1998 to 14.9% in 2007.[vi]

The debt-financed economic boom also enabled—temporarily—a national energy policy that was detached from costs and productivity. Spain's national government lavishly subsidized alternative energy production, especially solar, which experienced a boom of its own, making Spain the second-largest solar electricity producer in the world after Germany. President Obama has praised Spain's solar effort specifically and cast it as a model for the United States. But Spain could not sustain the high level of subsidies. When the subsidies were finally cut, much of the highly touted alternative energy investment was stranded and many workers were laid off.[vii] No matter how one assesses the environmental effects of solar-generated electricity with electricity generated by fossil or nuclear fuels, the subsidies wasted resources. Spain wants to continue the subsidization at a lower level and support "green" jobs.

Some U.S. policymakers still tout this effort, but the Spanish experience has proven nothing about the viability of alternative energy technology, the efficacy of Spain's particular approach to incentivize it, or the benefits of "green" jobs to the economy, except that fiscally unsustainable subsidies led to a bust. European vacationers have long known that Spain gets more sun than northern countries; it therefore may be a good location for solar panels, but there is no evidence that Spain has designed a better energy sector.

Spain has become a threat to European economic stability due to its large external debt (130% of GDP) and the question of whether its weakened economy can service its debts. The Spanish housing sector may not have hit bottom yet, unemployment now stands at 20%, and the recession has pushed the government budget deficit to 11% of GDP. The Spanish government debt-to-GDP ratio does not appear excessive at between 50% and 60% but may be nearing the limit of what financial markets will tolerate without substantially higher interest rates, given Spain's less than promising outlook for economic growth.

Conclusion

In the eyes of some, the euro-zone had created the same conditions for economic growth as the United States with a large economy and a single currency, but with more humane environmental and social policies. Many policymakers thought that America should adopt the European model. However, what has become apparent now is that a large market with a single currency and European-style environmental and social policies cannot substitute for increases in productivity, flexibility, and competitiveness to drive sustained economic growth. Spain did not put these preconditions in place and entered the euro-zone prematurely. Euro-zone entry enhanced Spain's ability to borrow abroad for a time and support costly energy initiatives but did not spur sustainable economic growth. Now euro-zone membership has become a hindrance to the country in that it cannot adjust its currency exchange rate to help make its exports more price competitive while it struggles with recession, indebtedness, and the challenges of structural reform. Unfortunately, for Spain and other euro-zone entrants, the European model did not offer a better way forward than the U.S. model.

Theodore W. Boll

Robert P. O'Quinn

---

[i] On January 1999, 11 EU Member-States adopted the euro: Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland. Since then, five more Member-States have adopted the euro as well: Greece (2001), Slovenia (2007), Cyprus (2008), Malta (2008), and Slovakia (2009).

[ii] "Greece at a Glance, Policies for a Sustainable Recovery," Organization for Economic Co-operation and Development (OECD), 2010.

[iii] All European Union (EU) Member-States form part of the Economic and Monetary Union (EMU) for which the Maastricht Treaty of 1992 sets the ground rules. In addition to the 16 euro-zone countries listed above, the EU also includes 11 Member-States for a total of 27: Bulgaria, Denmark, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Sweden, and the United Kingdom. The Maastricht criteria, also called the "convergence criteria," specify the conditions under which EU Member-States may adopt the euro as their national currency, such as maintaining annual government deficits of no more than 3% of GDP and gross government debt of no more than 60% of GDP.

[iv] OECD Perspectives: Spain, Policies for a Sustainable Recovery, Foreword, Organization for Economic Co-Operation and Development, 2010.

[v] Bruegel policy brief, March 2010, issue 2010/01, Table 1, p.3.

[vi] Ibid.

[vii] See, for example, "Spain's Solar-Power Collapse Dims Subsidy Model," by Angel Gonzalez and Keith Johnson, *The Wall Street Journal*, September 8, 2009.