The Current Southern European Crisis
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The origin of the crisis in many European countries (principally Greece, Portugal, Spain) is clear. When these countries adopted the Euro, they did not have the same level of “productivity, efficiency and technology” as their Northern neighbors (such as Germany, Netherlands, Scandinavian countries). Thus, they were already at a competitive disadvantage when they adopted the Euro (this situation is similar to the situation of Argentina when it introduced a Currency Board in 1990 to fix the peso to the dollar -- Argentina’s initial competitive disadvantage was the main factor behind its crisis of the late 1990s).

Nevertheless, despite their competitive disadvantage, Southern Europe was able sustain growth for a while by concentrating on (i) medium to low technology goods that were shipped principally to their richer neighbors thanks to free trade without tariffs, and (ii) non-tradable items, such as home/commercial construction activities and tourism. However, the higher productivity of Asian countries, particularly China, soon erased any advantage that Southern Europe had in low technology goods. Whereas as a result of the crisis, EU exports of good and services declined by only 2.5% between 2005 and 2010, during this period, exports declined by 24% in Italy, 12% in Greece, 7% in Spain, and 2.5% in Portugal. In addition, the liquidity crisis in the US had a negative effect on construction activities and tourism.

With weak export performance and low GDP growth, Southern European countries could not generate sufficient fiscal budget revenues to satisfy the aspirations of their populations in terms of higher pension payments and government wages. Also, they could not generate enough domestic savings to cover their domestic investment needs. They therefore resorted to large foreign borrowing to keep up living standards and investments. The levels of total foreign debt (public and private) owed to foreign banks exploded and reached $1.4 trillion for Italy (63% of GDP), $1.1 trillion for Spain (72% of GDP), $240 billion for Greece (75% of GDP), and $290 billion for Portugal (120% of GDP), according to Statistics of the Bank of International Settlements. These numbers do not include domestic debt (public or private) which is also denominated in Euros. In terms of government public debt (both domestic and foreign), in 2010 it reached 125% of GDP in Greece, 118% of GDP in Italy, 86% of GDP in Portugal, and 65% of GDP in Spain (EC numbers).

These countries were able to borrow heavily principally from banks in France, Germany and Britain. French banks lent $850 billion to these four Southern European countries, German banks, $520 billion, and British banks, $230 billion. No surprise that France and Germany have taken the lead in arranging bail out for these countries.
Furthermore, the international liquidity crisis put strains in the banks of the lending countries – particularly France-- which demanded higher interest rates and re-payments. Furthermore, the realization of the likely inability of Greece to generate sufficient funds to fully serve its debt led many major European financial institutions to question the creditworthiness of Greece and other Southern European countries.

The Southern European countries in fact, had “solvency” problems: they faced an inability to generate sufficient resources to serve their debt. However, the “support” arrangements so far discussed by the European Governments, the IMF and the ECB, are treating the problem, not as a “solvency” problem, but as a “liquidity” problem, thereby focusing on just injecting more funds (debt) into these countries. This is the main purpose of the $750 billion program proposed by the EC/IMF. These funds will bail out banks principally in France and Germany; but will not solve the fundamental problem of Southern Europe.

In fact, the “conditionality” of the EC and the IMF is that these countries should reduce drastically their fiscal deficits as a condition to the provision of funds. But fiscal austerity will cause major recessions in these countries, which will reduce even further tax revenues and fiscal budget revenues. With lower revenues, the countries will have even less resources to serve their debts. They will enter into a vicious cycle of low revenues and higher debt service later on. Although these fiscal austerity measures are needed, they are not sufficient to resolve the problem in a sustainable manner.

In fact, the experience of many developing countries, particularly in Latin America, shows that the injection of “liquidity” is not capable of solving a “solvency” issue. Fiscal austerity alone will not be able to resolve the issue on a sustainable way. During the debt crisis of 1982, these developing countries learned that they had to give primary importance to “structural economic reforms” to improve technology, efficiency and productivity. They had to take measures to improve their investment climate to attract significant amounts of foreign direct investments. Only then they will be able to generate economic growth and sufficient fiscal revenues to serve their obligations. Mexico experienced the same problem during the first financial crisis of the XXI century, in December 1994. At that time, Mexico was able to stabilize only when a major economic reform program was announced and implemented in March 1995, including not only fiscal austerity, but major reforms to improve the investment climate, such as large scale privatizations, labor market reform, banking sector reform, political reform, decentralization of government functions, reform of the legal/judicial systems, business deregulation, etc. Failure to show early commitment to structural reforms was deemed to be the major mistake of the Mexican authorities during December 1994-March 19995. The strong implementation of structural reforms in the last decade in many developing countries explains why many of these countries are now growing at a faster pace.

What Southern Europe needs to do is to emulate developing countries and take strong measures to attract foreign investments by removing barriers to business entry, business exit and growth. They need to reduce excessive corporate taxes, deregulate businesses, provide greater labor flexibility for firms, facilitate labor mobility across countries, improve the efficiency of public administration, reduce “social” benefits that increase the cost of doing business, etc.
But very little emphasis is given to these issues in the current dialog between EU countries, the IMF and the ECB. The earlier “Lisbon Agenda” attempted to deal with these structural problems and improve the technology/productivity deficiency of Europe; but after many years of inaction, it was a complete failure. They will learn the hard way (as Latin America did) that there are no short cuts.

The lesson for Ukraine is also clear: reducing its large fiscal budget deficit is a necessary but not a sufficient condition to re-establish its creditworthiness and sustainable economic growth. The country needs to implement a solid program of economic reforms to improve its investment climate and attract investments.

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