

OPINION

The Euro's Greek Tragedy, and Its Lessons for America

By David Malpass

Like many governments in the U.S., the Greek government has been spending and promising more than its tax receipts can finance, requiring it to place ever more debt with its lenders each month. This thrusts the country into a showdown with markets and lenders—and puts it at the focal point of the growing debt crisis rippling through U.S. states and municipalities.

On both sides of the Atlantic, government spending and unfunded retirement commitments continue to hit record highs. This discourages the new private-sector investment needed to create growth and all the good things that go with it: jobs, profits, house purchases and government tax receipts. The fundamental issue is whether government financial crises—in Greece, California, New York or elsewhere—will cause government spending reforms. If not, then growth, the dollar and euro are in further peril as markets force bailouts and waves of defaults.

An actual Greek debt default would shock big creditors like the German banks and threaten spillover market declines in other heavy debtors, slowing their growth. But for the international financial system, the even bigger risk is that Greece exits the euro. Beyond the economic devastation this would bring to Greece's people—whose net worth would convert from euros to weakening drachmas, one of the world's worst 20th century currencies—many other countries would find their markets and currencies facing heavy selling pressure, a repeat of the 1997 contagion during the Asian devaluation crises. The weaker countries within the eurozone would see investment flows dry up waiting to see the extent of the contagion.

The more likely Greek outcome is not default, devaluation or euro-supportive government restraint, but traditional growth-killing tax measures followed by subsidies, loan guarantees and bailouts by the International Monetary Fund and European Union. Since the support they provide is govern-

ment-to-government, not market-based, it will probably be conditioned on tax-hike austerity imposed on Greece's private sector. This doesn't address the core problem of growth, jobs and government spending restraint. The higher value-added tax already under discussion is decidedly not the upheaval in government spending, tax and regulatory policies also needed in Washington and many U.S. states.

The resolution of the Greek government's debt overhang has been seen as

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a critical factor in the euro's stability, though the European Central Bank's (ECB) resolve to maintain sound money is probably more important. Central banks control the supply of money and influence the demand for it, determining their currency's value. This is especially true for the ECB, which has a single mandate—price stability—unrelated to fiscal problems. The market's worry is that an ultimate bailout of Greece—or Spain, Italy or Portugal down the line—will weaken or change this mandate, forcing the ECB to create more euros than the market wants.

In contrast with many of the disastrous financial innovations of recent decades—excess bank leverage based on pro-cyclical capital adequacy ratios, securitizations based on faulty AAA bond ratings, opaque credit default swaps and the like—the sound-money commitment underpinning the euro worked well. The eurozone's expansion lifted living standards and employment, allowed European businesses to spend less time on cross-border currency volatility, drew eastern Europe away from Russia, and created an important alternative to the dollar as it was debased in the 2000s.

The Federal Reserve provides the cautionary example. It has fixed short-term interest rates on the dollar at

dangerously low levels—in 2003 at 1% and in 2010 near-zero. This allows heavily indebted governments and banks to borrow cheaply at the expense of savers, the dollar and long-term price stability. It also creates harmful distortions in capital flows away from smaller businesses and more productive areas of the economy.

Euro-skeptics worry that the ECB will head down the Fed path. Fortunately, Germany's taxpayer uproar over a Greek bailout and its post-Depression history of unwavering support for sound money—a sharp contrast with the Bush-Obama indifference to the dollar—argue that it won't copy the Fed's currency neglect.

A second worry challenging confidence in the euro is the 1990s view that the whole euro concept is inherently flawed, with Greece just the messenger of core governance problems. When the euro was created, advocates of a more centralized European political and financial union argued that the new currency couldn't work unless the nations using the euro

agreed on cross-border fiscal union. This implied bigger government with centralized taxing, spending and borrowing authorities.

The alternative view is that a stable currency has a tremendous value independent of other economic policies and can be maintained by a resolute central bank in spite of a fiscal mess. It shouldn't require a powerful central government or high tax rates to provide sound money. The U.S. founding fathers debated federalist issues extensively, creating a Constitution, explicit limits on the powers of the federal government, and a legally united base for the dollar. Those debates are still wide open in Europe, with Greece and its fiscally weak neighbors in southern Europe forcing a key test and at least temporary weakness in the euro.

Since stable money is so valuable in terms of jobs and capital flows, and has been hard for spendthrift governments to achieve, this euro conflict—over the ECB's ability to reinforce the soundness of the euro and restart its spread into non-euro coun-

tries—is probably the most important outcome of the Greek crisis. A positive development would be substantial new restraint on Greece's government spending. This would begin the necessary reduction in its debt-to-GDP ratio, currently well over 100%. Since markets look forward and react quickly, a pro-growth direction would invite new investment and jobs in Greece's private sector, not the deeper recession Keynesians fear from slower government spending.

Central governments are moving even deeper into the guarantee/bailout business. This creates short-term stabilization, but at immense cost to long-term growth and currency stability.

The better outcome from 2010's rolling debt crises would be for the taxpayers who will foot the subsidies and loans to insist on spending restraint. Indeed, what's needed is an antispending upheaval within heavily indebted governments.

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