

Europe finds the old rules still apply

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The cruel irony of the euro area's predicament is that, in many ways, the whole exercise was designed to produce the very credit explosion that bedevils it today. After all, one of the driving motivations of the euro was to enable member states to compete with the US for a share of the global reserve currency business. Reserve currency status, in turn, is the essence of America's "exorbitant privilege" (a term coined by Valéry Giscard d'Estaing, the former French president). The most important perk the US gets is the ability to issue debt at a lower interest rate than would otherwise be the case. Indeed, recent research suggests that simply by enhancing the size and liquidity of financial markets, the euro may have helped to lower real interest rates across Europe, and not just for government borrowers.

Lower interest rates, in turn, helped fuel greater borrowing, especially in the countries of the eurozone periphery. Thus, the spreading debt crisis is as much a product of the "success" of the euro as of its failure. The euro was designed to be a superior debt financing machine and, to a considerable extent, it has delivered. Unfortunately, it should have come with a warning sign: Europe's leaders were far too quick to admit members who might have been better served with a much longer probation period. The Maastricht treaty and, more importantly its implementation, was simply too forgiving, especially for countries with chequered financial histories.

A recurring theme of my academic research with Carmen Reinhart is that "graduation" from emerging market status is a long, painful process that can take 75 years or more to complete. Twenty years without, say, a sovereign debt crisis is significant, but hardly enough definitively to declare a country a "graduate". Greece resolved its last sovereign default only in the mid-1960s and Portugal had an International Monetary Fund programme as recently as 1984. (Spain's modern history is much better, despite holding the record – more than 12 – for most independent sovereign default episodes.)

The eurozone experiment was, in effect, an attempt to speed up the graduation process through the carrot of the single currency and the stick of harsher bail-out rules. Instead of having to demonstrate fortitude and commitment through decades of surpluses and declining public debt levels (as for example, Chile has done), euro members were allowed to have their cake and eat it, too. Instead of starting to hit a ceiling at 90 per cent of gross domestic product as might a "normal" emerging market country, Greece could run up its public debt to more than 115 per cent of GDP. Even more stunning a figure is Greece's total external debt to GDP, which is more than 170 per cent, counting both public and private debt. Prof Reinhart and I find that most emerging markets run into trouble at external debt levels of merely 60 per cent of GDP. Indeed, the external debt levels of Spain, Portugal and Ireland are all sky high if one were to judge them by emerging-market standards.

Is it realistic for the IMF and Europe to hope that Greece (and other struggling euro members) will survive without an eventual default? It can happen but it is not easy. In recent years, South Korea, Turkey and Mexico have all skirted sovereign default thanks to massive external assistance, albeit with significant private sector external defaults. Unfortunately, "near misses" are the exception, not the rule. Indeed, there are many cases where even an IMF programme is not enough to solve the problem. Argentina, Indonesia, Uruguay and the Dominican Republic all provide very recent examples where a government adopted an IMF programme but defaulted eventually anyway.

Will Europe's crisis end only in "near misses" rather than outright defaults or reschedulings? The answer involves a range of political, social and economic questions that are not easily quantifiable. Economists have only a limited understanding of why sovereign nations ever repay their external debt, given the lack of any supranational legal authority that might force them to do so. It is very rare for a country to default because it literally cannot pay. In most cases, and certainly in southern Europe today, the issue is willingness to pay. Romanian dictator Nicolae Ceausescu famously forced his people to endure cold winters with minimal heat to help his country repay \$9bn owed to foreign banks in the 1980s. Had he been able to wait a few years, Romania would probably have enjoyed the same kind of partial debt forgiveness extended to many others at the end of that decade. The fact that a country can repay its debt does not necessarily mean it should choose to do so.

In the case of Europe, the decision to repay involves not only the usual costs and benefits, but also the added question of how a nation's status in the European Union will be affected. Is Europe prepared to go to great pains to punish Greece if it defaults, imposing costs much higher than those a non-euro country would face? If not, how can it seriously expect Greece to pay down debt levels far in excess of those navigated by almost any other large emerging market?

In our book on financial history, Prof Reinhart and I find that international banking crises are almost invariably followed by sovereign debt crises. Will the euro prove to be a firewall against this process, or a debt machine that fuels it? It is going to be extremely difficult for some of the peripheral eurozone economies to escape without large-scale defaults on their massive private external debts, public external debts, or both.

*The writer is professor of economics at Harvard and co-author with Carmen Reinhart of *This Time is Different**

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