

# WebMemo



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## Ten Economic Lessons from Europe for the U.S. President

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As the debate over America's debt burden intensifies, the Eurozone's social and economic problems provide a warning to the United States. Portugal is the latest Eurozone country seeking a multi-billion-dollar bailout from the international financial community, despite the fact that such a move would create *at least* as many problems as it would solve. Greece and Ireland have both been bailed out but still face the possibility of a sovereign default as they continue to struggle with a lack of growth and low levels of competitiveness.

As the U.S. tackles its own fiscal situation, here are 10 lessons that it can learn from the European experience.

**1. Financial Markets Will Eventually Lose Patience.** The primary lesson from the Eurozone sovereign debt crisis is that running large deficits and accumulating debt with no indication of changing will *always* translate into higher interest payments and likely higher interest rates, meaning more tax revenue will be consumed just paying for past fiscal sins. Greece, Ireland, and Portugal are now facing interest rates of 13 percent, 10 percent, and 9 percent, respectively, and still face the very real possibility of defaulting.

The U.S. is on dangerous ground by not tackling its current and future deficits with enough urgency. The Obama Administration seems to be relying on markets continuing to provide it with near unlimited liquidity at reasonable rates. But this cannot last forever. Even absent a fiscal correction, interest

rates are widely expected to rise substantially in the next few years as the global economy rebounds. For example, the Administration forecasts a rise in the 10-year Treasury rate of 230 basis points. Add in the ongoing deficits, and investors will eventually give the United States the Irish treatment, raising the cost of borrowing much more.

**2. Time Is of the Essence.** European politicians (and taxpayers) have learned the hard way that inaction comes with a higher price tag than taking action. Failure to address the Eurozone crisis early on has seen the costs spiral and the contagion spread. American political leaders would do well to learn that even when they do nothing, economic problems continue to mount.

**3. Central Banks Can Become Part of the Problem.** The European Central Bank (ECB) is in trouble. It is over 24 times leveraged,<sup>1</sup> it has taken on mountains of risky Eurozone government debt, and it is massively exposed to essentially insolvent banks and governments. Its capital and reserves could be wiped out by a loss of just 4 percent on its assets, whereby it would have to be recapitalized by already strapped governments or print money just to survive.

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Pumping liquidity into an undercapitalized banking system does not work. Rather, it increases risky exposure and threatens to stoke inflationary pressures.

**4. In Europe, This Crisis Started with the Banks, and That Is Where It Will Finish.** There is no escaping bad banks. In Ireland, the cost of bailing out the banks has topped €70 billion (\$102 billion) in the past year alone. Struggling banks continue to borrow €450 billion (\$653 billion) from the ECB at rates far below those they would face on the open markets. However, providing liquidity to essentially insolvent banks has simply created a series of European “zombie” banks that are reliant on ECB funding and survive only because of it. This is not a sustainable solution. For example, over 110 U.S. banks borrowed heavily from the Federal Reserve before eventually going bust. It is wasted public money.<sup>2</sup>

Effective stress testing that counts the true level of sovereign debt and a mechanism for winding down insolvent banks should have been formulated at the start of the crisis. Europe does not need another round of stress testing that rigs the results.

**5. Beware of Politically Motivated Financial Regulation.** Much of Europe’s post-crisis financial regulation has been a chance for politicians to push through regulations based on long-held prejudices and ideological persuasions rather than economic sense. Regulations on short-selling and hedge funds and proposed taxes on financial transactions threaten the health of European financial markets while solving none of the underlying issues behind the financial crisis.

There are similar inclinations in the U.S., where the government has imposed excessive regulation on hedge funds and private equity firms. Such misdirected laws could substantially damage market liquidity and waste congressional time and taxpayers’ money. Perhaps most damaging of all, excessive regulations already contribute to the steady migration of financial service providers abroad; threats to impose an even heavier regulatory burden can only accelerate the migration.

**6. Protectionism Backfires.** Politicians’ instinctive reaction to close off the economy when a crisis hits must be resisted. Free trade supports economies even in hard times. A successful conclusion of the Doha Round could result in \$164 billion in aggregate benefits for the U.S.<sup>3</sup> The U.S. risks shooting itself in the foot by blocking free trade deals with South Korea, Colombia, and Panama. Even the EU, famed for its external trade barriers, is pressing ahead with free trade agreements with South Korea and India.

**7. Don’t Do Cap and Trade.** Emulating Europe’s cap-and-trade system would be a disastrous mistake for the U.S. The flaws are numerous, and Europe’s few “green jobs” have come at the expense of many more real jobs in other sectors.<sup>4</sup> The system has also been hampered by fraud, and the build up of free permits continues to depress the carbon price to the point where it is completely ineffective.

**8. “Social Welfare” Can Bring Down an Economy.** Several European countries have learned the hard way that massive pension liabilities, generous benefit systems, and bloated public health care can lead to tax levels and government spending that

1. The figures for subscribed capital and reserves are based on the weekly financial statement of March 18, 2011 (available at <http://www.ecb.int/ecb/orga/capital/html/index.en.html>). See also: Press release, “Consolidated Financial Statement of the Eurosystem as at 18 March 2011,” European Central Bank, March 22, 2011, at <http://www.ecb.int/press/pr/wfs/2011/html/fs110322.en.html> (April 26, 2011). The level of leverage is determined by the ratio of assets to the capital and reserves held by the bank.
2. Binyamin Appelbaum and Jo Craven McGinty, “Fed Helped Keep Banks Afloat, Until It Didn’t,” *The New York Times*, April 4, 2011, at <http://www.nytimes.com/2011/04/05/business/economy/05fed.html?partner=rss&emc=rss> (April 26, 2011).
3. C. Fred Bergsten, *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (Washington, DC: Peterson Institute for International Economics, 2005), pp. 32–42.
4. A study by Gabriel Calzada Álvarez at King Juan Carlos University found that for every green job created, 2.2 jobs in other sectors have been destroyed. See Gabriel Calzada Álvarez, “Study of the Effects on Employment of Public Aid to Renewable Energy Sources,” King Juan Carlos University of Madrid, March 2009, at <http://www.juandemariana.org/pdf/090327-employment-public-aid-renewable.pdf> (April 26, 2011).

will break the back of the economy. And it gets worse: The *unfunded* liabilities of pension schemes and social security systems across Europe reveal a gargantuan debt problem that is only worsened by European demographic trends.

The U.S. faces similar problems. The European experience demonstrates that putting off unpopular decisions can be far worse in the long run than making tough decisions in the near term.

**9. Persistent, Excessive Trade Imbalances Are Warning Signs of an Unhealthy Economy.** One common feature among all the struggling European economies is that they ran massive trade deficits in the years leading up to the crisis; the U.S. continues to do so as well. In several European economies, the adoption of the Euro resulted in artificially low borrowing costs that encouraged more borrowing and led to fiscal and trade deficits.

America's long-term trade deficit represents many factors, including low rates of domestic saving relative to domestic investment rates. U.S. households, businesses, and government need to pay attention to the European experience. Despite the temptation of taking on cheap debt, savings are needed as an added economic buffer, especially in times of crisis.

**10. Credibility Counts.** People often complain about politicians being all talk and no (or unwise) action. Never is this truer than in an economic crisis. Financial markets respond poorly if they believe that a government has lost the ability or willingness

to act responsibly. Both the public and the markets punish those who do not produce real, credible policies and act decisively. And once a government loses its credibility, it is nearly impossible to find a way back.

**U.S. at a Crossroads.** Unlike many of its continental partners, the new Conservative-led government in Britain has chosen to swallow the bitter pills of austerity cuts and deficit reduction. Unfortunately, it swallowed a huge tax hike as well. Sweden, which is also outside the Eurozone, has successfully steered its economy through this crisis. Having learned valuable lessons in the 1990s, Sweden's center-right government has chosen to incentivize work and maintain budget discipline, which has led to economic growth of 4.5 percent in 2010.

The U.S. now faces a similar choice: It can continue to pursue the failed socialist policies that have put most of Western Europe in an economic hole, or it can learn from Britain and Sweden and allow the free market to weather the current storm. There is still time to make the right choice.

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