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How Contagious Is Europe's Economic Crisis?

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Abstract
Europe's economic problems are already affecting the U.S. economy. An expanding European crisis could affect the U.S. through the financial sector, reduced demand for U.S. exports, disruption of global supply chains, and political disruption in Europe. The U.S. can best help Europe by pursuing sound economic policies at home, starting with pulling back from the approaching fiscal cliff. The U.S. should also encourage European states to implement policies that foster free markets, lower their tax rates, and reform their unsustainable welfare systems.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2726**

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Key Points

- Europe's deepening crisis is already affecting the U.S. economy through lower exports and higher uncertainty.
- The financial sector is the channel that is most likely to transmit harmful effects of a European crisis to the U.S. economy.
- The European Commission's own economists understand that improving long-run growth will require structural reform.
- The long-run health of European economies depends on market liberalization and structural reform. Short-run solutions will not avail Europe unless the foundation is laid for a future of economic freedom and growth.
- The U.S. can best help Europe by restoring economic growth at home. That entails dealing with the fiscal cliff this year and addressing the explosive growth of entitlements and government debt.

Many countries in the eurozone are on the brink of financial insolvency. Large, global European banks could fail. The eurozone could break up. Any of these potential negative outcomes would be felt well beyond the borders of Europe.

A European economic crisis could affect the U.S. economy through several channels:

- **Current effects.** The U.S. is already affected by lower demand for exports and higher uncertainty in Europe.
- **The financial sector.** The financial sector is the channel most likely to transmit Europe's recession to the U.S. European banks are at risk because of their extensive holdings of government debt.
- **Demand.** The U.S. exports $240 billion annually to the European Union (EU). Severe recession in Europe would further weaken U.S. exports and the prospects for economic growth.
- **Supply.** Disorderly exits from the eurozone could disrupt global supply chains and could hurt short-run growth in the U.S. In the long run, Europe needs to

liberalize its markets in order to contribute to global growth.

- **Political effects.** Europeans are not immune to electing bad leaders. Elections in Europe could damage cooperation on a variety of fronts, from NATO to trade policy. Without reform, Europe's future looks bleak.

In the short term, American policymakers should address the "fiscal cliff," which poses great risks to the U.S. economy. Stability in America would ease Europe's path out of its own crisis. For the long term, America should emphasize how free markets, low tax rates, and welfare reform have allowed the U.S. to maintain its income advantage over Europe.

Current Effects

There is no need to wonder whether the prospect of European economic problems will affect America's economy. It is already affecting economic decisions. However, Europe's uncertainty is not the primary cause for the slow U.S. economic recovery since 2009. Overregulation, ballooning deficits, and looming tax increases in 2013 are larger and more direct drags on American growth.[1]

Currently, the crisis unfolding across most of Europe affects the U.S. economy in four distinct ways:

- **The current economic slowdown in Europe reduces demand for U.S. exports.** Consumption in the eurozone has grown at an annual rate of 1.0 percent since the beginning of 2008, compared with 3.6 percent annually over the previous four years. Even worse, eurozone imports have declined from a 2007 high.[2] The European divisions of U.S. multinationals, such as Ford and General Motors, have lost money as sales have declined.[3] U.S. goods exports to Europe dropped 20 percent from a high in 2008 to a low in 2009 and then recovered rapidly over the next two years. U.S. exports to Europe grew 11 percent from 2010 to 2011—much faster than the overall economy.[4] However, year-over-year growth slowed to less than 2 percent in the first six months of 2012.[5]

- **Uncertainty about the euro's future has kept the dollar expensive, making U.S. exports less competitive.** Although how expensive the dollar would be in the absence of European uncertainty is unknown, risk-averse investors fleeing euro-denominated assets have driven up the price of the dollar. Although many factors affect exchange rates, the uncertainty about the eurozone has probably driven the yearlong increase in the price of the dollar.

- **Uncertainty about the health of European banks has led U.S. money market funds to disengage.** Fear of a European banking collapse compels U.S. investors to eschew potentially profitable investments in European money markets. Thus, Americans' retirement funds, mutual funds, and other investments are slightly less profitable than they would be if European banks were on firm footing.

- **Political and economic uncertainties dissuade risk taking.** Uncertainty about Europe's future and the extent of future crisis transmission make U.S. investors more cautious and less innovative, slowing growth and technological progress. Long-term economic growth is driven by lowering the costs of production and increasing the product varieties available to consumers. Entrepreneurs, managers, and venture capitalists are less likely to take the risks that increase productivity when the future markets for their products are uncertain.

Financial-Sector Effects

The financial sector in Europe has been on doubtful footing since the 2008 crash. A European financial panic of any variety could have significant global repercussions, and the financial sector is the most important transmission mechanism from Europe to the U.S.

Government Debt. European banks are more deeply connected to their respective governments than American banks are to the federal and state governments. Despite the common currency, eurozone

1. Congressional Budget Office, "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022," August 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43539-08-22-2012-Update_One-Col.pdf (accessed September 5, 2012).
2. European Commission, Eurostat database, Consumption at Local Prices for the Euro17, 2003–2011.
3. Associated Press, "How Europe's Debt Crisis Is Affecting US Economy," Bloomberg Businessweek, June 8, 2012, http://www.businessweek.com/ap/2012-06/D9V958P80.htm (accessed June 26, 2012).
4. U.S. International Trade Commission, Interactive Tariff and Trade DataWeb, Domestic Exports to the EU27, 2003–2012. Figures are in nominal prices.
5. Ibid.

banks hold large shares of their own governments' debt: In Greece and Germany, domestic banks hold around 20 percent of domestic government debt, and Spanish banks hold almost 30 percent of Spain's debt.[6] Other domestic institutions, such as pension funds and insurance companies, hold even more domestic debt.

The interconnectedness—or codependency[7]—of government and banks means that a crisis in one can cripple the other. For instance, if the risk of sovereign default rises, domestic banks would find that their assets are much less valuable and would face the nasty choice of refusing to roll over government debt—which would precipitate a crisis—or agreeing to lend the government the funds needed to pay back the banks, further entangling the two sides. Most European banks have chosen the second option, digging furiously to escape the hole in which they are trapped.

Government risk or failure can affect banks in other ways. In Greece, the fear of a euro exit and forced conversion of Greek bank deposits into drachmae has led many depositors to withdraw their savings from Greek banks and move their money abroad.

On the other side, if banks fail first, the government's best bond-market customers are bankrupt. With diminished demand for government bonds—not to mention the recession that often coincides with bank failure—yields on government debt would rise. With fewer customers for more debt, a government with a relatively healthy debt-to-GDP ratio can suddenly find itself at risk of defaulting.

Spain exemplifies contagion moving from banks to government. Spain's banks were loaded with mortgages that went bad when the country's housing bubble popped. Despite modest debt and budget surpluses in six of the seven years preceding the crisis,[8] the bank crisis caused the government to lose control of its financing.

Regrettably, the codependency does not stop at national borders. As of March 2012, French banks owned almost half of the $722 billion of Italian debt held by foreign banks and more than half of the $79 billion of Greek debt. Spanish and Portuguese banks were mutually entangled. The U.K. and Belgium owned too much Irish debt, and the Netherlands owned a significant amount of Spanish debt.[9]

The good news for Americans is that the U.S. is relatively insulated from the European tangle of banks and government debt. As of March 2012, American banks owned only $132 billion of debt issued by European countries that are currently in crisis.[10] Even if that debt loses a large portion of its value due to default, their total exposure is modest.

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Money Markets. A primary form of international financial integration is the world of money market funds. These are low-risk, low-return funds that allow investors to earn modest returns on liquid assets. Money market funds purchase low-risk commercial and government bonds.

Because corporations tend to maintain working relationships with specific funds, losses in a fund can affect not only money market investors in that fund, but also corporations that rely on that fund to market their debt. Economists have found evidence that when a fund needs to shrink its asset base, its usual borrowers find it more difficult to issue new debt.[11]

Sergey Chernenko and Adi Sunderam have documented that American prime money market funds rapidly divested from European banks during the summer

6. Silvia Merler and John Pisani-Ferry, "Who's Afraid of Sovereign Bonds?" *Bruegel Policy Contribution*, No. 2012/02, February 2012, http://docs.jean-jaures.net/NL470/21.pdf (accessed June 26, 2012).
7. Daniel Woolls and Harold Heckle, "Spain's Banks, Government Co-Dependent on Debt," Associated Press, June 25, 2012, http://www.sfgate.com/business/article/Spain-s-banks-government-co-dependent-on-debt-3660227.php (accessed June 26, 2012).
8. World Bank, World Development Indicators, "Cash Surplus/Deficit as % of GDP," 2001–2007.
9. Bank for International Settlements, Monetary and Economic Department, *Detailed Tables on Preliminary Locational and Consolidated Banking Statistics at End-March 2012, July 2012*, pp. A90–A101, Table 9D, http://www.bis.org/statistics/rppb1207_detailed.pdf (accessed September 4, 2012). Data include debts from all sectors of the economy, including financial, public, and private sectors. Data include only debt held by banks in the 24 countries that report to the BIS.
10. Ibid. The text refers to End-March 2012 data on debt issued by Greece, Ireland, Italy, Portugal, and Spain.
11. Sergey Chernenko and Adi Sunderam, "The Quiet Run of 2011: Money Market Funds and the European Debt Crisis," working paper, January 23, 2012, http://www.cob.ohio-state.edu/~chernenko_1/papers/mmmfs.pdf (accessed June 25, 2012).

of 2011.[12] The "slow motion run" on European banks reduced U.S. money market exposure from $453 billion (27 percent of all prime money market funds) to $287 billion in August 2011 and $154 billion at the end of 2011.[13] As investors withdrew money from money market funds with heavy euro exposure, American corporations that usually financed through those funds decreased their issuance of new debt.[14]

U.S. money market investment in Europe stabilized during the first half of 2012, ending in May at $199 billion (14 percent of all prime money market funds).[15] Hopefully, given the robust attention that investors give to this form of European exposure, the risk and return of euro-invested money market funds are at a desirable level for American investors. Although the failure of one or more major European banks would hurt American money market investors, money markets have already had time to divest from the riskiest banks. At worst, a European bank collapse could lead to another money market "run" on European banks and a slowdown in corporate borrowing, albeit a less severe run than occurred in 2011.

Credit Default Swaps. As Americans learned when the subprime mortgage bubble burst, credit default swaps (CDS) are an impressive financial lever. Swaps leverage investment, allowing more investment with a given amount of capital, but can also multiply the damage of a financial collapse.

The main trouble with swaps is that they lack transparency. They are often difficult to price. The market for swaps disappeared once the U.S. housing bubble burst, and a similar paralysis could result if a major European government or bank fails. If so, those who own swaps would be stuck with an illiquid asset of questionable value.

The Bank for International Settlements (BIS) reports that U.S. banks had $638 billion in "Other potential exposures"—including CDS and similar instruments[16]—to Portugal, Ireland, Italy, Greece, and Spain (PIIGS) as of March 2012. This potential exposure dwarfs the direct exposure of U.S. banks to PIIGS debt, which stood at only $132 billion.[17]

Furthermore, other U.S. financial entities—such as mutual funds, union pension funds, and hedge funds—have additional exposure not counted by the BIS, although their exposure is probably much smaller.[18] Likewise, potential exposure to French and Dutch debt derivatives is as large as potential PIIGS exposure.[19] It is difficult to put an upper limit on the amount of American investment at risk if the crisis compounds with failures in the eurozone's core.

The good news is that investors are more aware of the issues surrounding CDS than they were in 2008. As the European debt crisis drags on month after month, financial institutions have the time to evaluate their holdings properly and rebalance as necessary.

U.S. policymakers can lay a foundation for sober preparation by making it crystal clear that the federal government will not bail out banks or funds that lose money from European fallout. When managers know they must live with the consequences of their decisions, they tend to invest more prudently.

Corporate Bond Contagion. Economists at the Federal Reserve Bank of San Francisco estimate that bond yields in the U.S. and Europe move together.[20] Using a narrative econometric approach,[21] they

12. Ibid.
13. Richard Leong, "U.S. Money Funds Pared Euro Zone Debt in May—JPMorgan," Reuters, June 12, 2012, http://www.reuters.com/article/2012/06/12/us-markets-usa-moneyfunds-jpmorgan-idUSBRE85B13C20120612 (accessed June 27, 2012).
14. Chernenko and Sunderam, "The Quiet Run of 2011," pp. 17–20.
15. Leong, "U.S. Money Funds Pared Euro Zone Debt in May."
16. Stefan Avdjiev, "Exploring the Relationship Between 'Guarantees Extended' and CDS Sold," Bank for International Settlements, September 19, 2011, http://www.bis.org/publ/qtrpdf/r_qt1109v.htm (accessed June 27, 2012).
17. Bank for International Settlements, *Detailed Tables*, pp. A102–A111, Table 9E.
18. Data examined by the European Central Bank shows that non-banks make up around 10 percent of the CDS market. European Central Bank, *Credit Default Swaps and Counterparty Risk,* August 2009, http://www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf (accessed August 1, 2012).
19. Ibid.
20. Galina Hale, Elliot Marks, and Fernanda Necchio, "Are U.S. Corporate Bonds Exposed to Europe?" Federal Reserve Bank of San Francisco, *FRBSF Economic Letter,* June 4, 2012, http://www.frbsf.org/publications/economics/letter/2012/el2012-17.pdf (accessed June 27, 2012).
21. A narrative approach uses subjective analysis of the historical record to create a data series. In this case, Hale et al. used the historical record to identify negative shocks originating in European politics.

find that when European corporations experience a 100-basis-point increase in the cost of borrowing due to European economic uncertainty, the cost of borrowing for American corporations increases by 44 to 85 basis points. This effect is driven by international linkages in borrowing costs for highly rated financial firms and low-rated nonfinancial firms.

This evidence suggests not only that investors believe that the largest—and usually safest—U.S. financials are the most globally integrated,[22] but also that fiscally weak U.S. nonfinancial companies have the most to lose from a European recession.

The existence of yield contagion directly contradicts the hopeful (or cynical) hypothesis that weak financial markets in Europe make more lending available in the U.S. Instead, the opposite is true in the private sector. For federal government borrowing, any such gains would come through lower interest rates. Since rates are already near zero, there is little room for improvement.

Demand Effects

Even as eurozone leaders take necessary steps to avoid a worst-case scenario (see text box, "How a European Recession Could Affect U.S. Growth: IHS Global Insight Forecast"), parts of Europe are already in recession. The EU reported negative growth in 2011 for Greece, Portugal, and Slovenia,[23] and the European Central Bank projects that the eurozone is already in a recession that will last into 2013.[24]

As noted, Europe is a key market for American exports. With slowed growth, Europeans are poorer and demand fewer American goods. Increased uncertainty in Europe will also translate into a stronger U.S. dollar against foreign currencies. When the dollar is more expensive, American exports are less competitive, and European uncertainty hurts American exports around the world.

While a stronger dollar and slower growth in foreign economies diminish U.S. exports, reduced European demand for basic commodities, fuel, and Chinese goods could lower the prices of major U.S. imports. Thus, lower import prices would partially offset the effects of a recession in Europe. Any further downturn in Europe—and any continued collateral damage to other world economies, especially major U.S. trading partners—would translate into lower demand for U.S. exports and overall growth expectations.

This channel of economic contagion is powerful but limited. Almost nothing can be done to avoid negative spillovers from a recession. Certainly, ginning up demand with government spending would be counterproductive in both the short run and the long run because it would increase the risk that the U.S. would follow Europe into debt crisis and austerity. A severe EU recession might decrease U.S. exports to Europe as much or more than the $50 billion drop from 2008 to 2009. Although that amount is large, decreased imports would dynamically offset some of it, and $50 billion represents only 0.03 percent of the U.S. economy.

The best silver lining to a European recession would be for European voters and leaders finally to decide to scrap the static model of economic activity on which socialist economic policies are based. Static economic models assume that jobs exist by fiat and can be molded and distributed as politicians desire. Dynamic economic models recognize that jobs are created and destroyed following market incentives, not political wishes. The global economy needs a dynamic, growing Europe, employing 95 percent of its labor force and inventing, investing, creating, and consuming.

Supply Effects

A mild recession in the eurozone would have benign supply effects on the U.S., but a breakup of the eurozone or a European depression would transmit negative supply effects.

A recession in Europe would have both positive and negative supply effects on the U.S. economy. Prices would fall due to decreased European demand for oil and other resources, benefiting U.S. consumers and firms. Cheaper inputs for U.S. producers would increase profitability, enabling them to hire more workers and pass savings on to consumers. On the negative side, some European companies that supply intermediate goods to American producers would go out of business, forcing American producers to find higher-cost

22. See also Avi Salzman, "Why Morgan Stanley, Goldman Are Trading Like European Banks," *Barron's,* June 15, 2012, http://blogs.barrons.com/stockstowatchtoday/2012/06/15/why-morgan-stanley-goldman-are-trading-like-european-banks/ (accessed June 27, 2012), and Stephen Gandel, "Wall Street's Hidden Europe Risk," *CNN Money*, June 12, 2012, http://finance.fortune.cnn.com/2012/06/12/europe-risk-wall-street/?iid=HP_LN (accessed June 27, 2012).

23. European Commission, *European Economic Forecast*, Spring 2012, p. 10, http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf (accessed July 17, 2012).

24. European Central Bank, "ECB Staff Macroeconomic Projections for the Euro Area," September 2012, http://www.ecb.int/pub/pdf/other/ecbstaffprojections201209en.pdf, (accessed September 7, 2012).

TABLE 1

What a Disorderly Greek Exit from the Euro Could Mean for the U.S. Economy: IHS Global Insight Model Forecast

	2012	2013	2014
Real Gross Domestic Product Growth Rate (Change from Prior Year)			
August 2012 Pessimistic Forecast	1.7%	–0.6%	1.5%
August 2012 Baseline Forecast	2.1%	1.8%	2.8%
Difference from Baseline Forecast	–0.4%	–2.4%	–1.3%
Total Exports of Goods and Services Growth Rate			
August 2012 Pessimistic Forecast	4.2%	–1.5%	4.0%
August 2012 Baseline Forecast	4.9%	4.9%	6.1%
Difference from Baseline Forecast	–0.7%	–6.5%	–2.1%
Total Employment (Level Amount, in Thousands)			
August 2012 Pessimistic Forecast	133,025	132,822	133,297
August 2012 Baseline Forecast	133,210	135,024	137,208
Difference from Baseline Forecast	–185	–2,202	–3,911

Note: This model of the U.S. economy is owned and maintained by IHS Global Insight, Inc., the leading economic forecasting firm in the United States. The IHS Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy would likely affect major economic indicators. The IHS Global Insight economists provide a baseline forecast of the U.S. economy. The "pessimistic" forecast scenario assumes a severe contraction in the eurozone which impacts the U.S. economy. There are no effects of the "fiscal cliff" from 2012 to 2013 because the pessimistic forecast scenario assumes that Congress will not let deficit reduction and tax rate expiration occur until at least 2014. Thus, if the economy goes over the fiscal cliff in 2013, even this "pessimistic" forecast scenario is too rosy.

Source: Heritage Foundation calculations using data from IHS Global Insight.

suppliers. Furthermore, as outlined above, tighter credit conditions can prevent American companies from investing in capital and labor, thereby slowing their growth.

Negative supply shocks can create a recession in the short run. If a severe European crisis emerges, Americans should expect a U.S. recession (negative GDP growth) as well.

A major crisis in Europe would cause European producers to fail and spark a sharp drop in European imports from the rest of the world. In particular, a breakup of the eurozone

How a European Recession Could Affect U.S. Growth: IHS Global Insight Forecast

How would a European recession affect U.S. growth? Analysts at IHS Global Insight, using a large-scale macroeconomic model, forecasted the likely impact on the U.S. economy of a "pessimistic" scenario in the eurozone.[25] This pessimistic scenario assumes an abrupt and disorderly Greek exit from the euro with significant damage to the European economy. A disorderly Greek exit would incorporate many of the transmission channels discussed in this paper. The baseline forecast scenario incorporates an orderly Greek exit, which has little effect on the U.S.

In the pessimistic economic outlook, there would be a dramatic reduction in economic growth expectations in the eurozone and other world economies. The weaker growth in major U.S. trading partners would reduce U.S. exports by about $34 billion instead of the baseline prediction of a $109 billion increase in exports, leading to slower U.S. growth in 2013. According the IHS Global Insight August 2012 pessimistic scenario forecast, U.S. GDP would contract 2.40 percent in 2013 relative to the baseline. (See Table 1.)

25. This model of the U.S. economy is owned and maintained by IHS Global Insight, Inc., the leading economic forecasting firm in the United States. The IHS Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy would likely affect major economic indicators. The IHS Global Insight economists provide a baseline forecast of the U.S. economy. The "pessimistic" forecast scenario assumes a severe contraction in the euro zone that affects the U.S. economy. There are no effects of the "fiscal cliff" from 2012–2013 because the pessimistic forecast scenario assumes that the U.S. Congress will not let deficit reduction and tax rate expiration occur until at least 2014. Thus, if the economy goes over the fiscal cliff in 2013, even this pessimistic forecast scenario is too rosy.

would disrupt trade within Europe because businesses would need to adjust to a new money regime on the fly. Many would likely adjust by contracting, specifically by closing plants in countries that lost stability or competitiveness in the crisis.

Supply chains in many industries are thoroughly globalized. American producers rely on particular suppliers to make specialized parts. Likewise, many American manufacturers make parts that end up in final goods produced in Europe.

For instance, *The Economist* recently reported that 40 percent of the value of each airplane built by Airbus originates in the U.S.[26] If European firms fail or contract, their American suppliers and producers will suffer. The U.S. exported $268 billion to the EU in 2011,[27] amounting to 1.8 percent of U.S. GDP, and imported a similar amount. Much of that trade is in intermediate goods and between companies. Disrupting these links would slow production at some U.S. firms and lead to plant closures.

However, the worst supply effects are those felt in the long run. Worldwide technological innovation and increasing efficiency drive material improvement in modern life. If Europe experiences an extended depression, many of its entrepreneurs, inventors, and innovators will fall idle. As bad as the current trough is, the lost potential of the past few years pales in comparison with the potential that will be lost if Europe remains on its current, uninspiring growth path.

Since the 1970s, Europe has offered a clinic in bad economic policy. Decreased labor freedom and an expanding welfare state ended Europeans' postwar convergence with U.S. living standards. Instead, Europe settled into a below-potential growth path, well behind the U.S. Unemployment rose and labor force participation stagnated, depriving the world of the economic contributions of many Europeans.

Continuing the rotten policies of the past into a severe crisis would make them even more destructive. During times of economic transition, market inflexibility will keep more people out of work longer and reward companies with political connections instead of companies with efficient innovations. Future American consumers would be poorer in a world with less European innovation.

Political Action or Inaction?

Without far-reaching liberalization, Europe's economies cannot grow and thrive. The anti-competitive restrictions in most European economies will prevent rapid growth regardless of the euro's fate.

Euro Exit. The most obvious potential political action would be the breakup of the eurozone. This may occur in many different ways, most likely leaving behind a core of Western European countries that continue to use the currency. In some versions, the weakest economies and most troubled governments will drop out or be kicked out: first Greece, then others from among Ireland, Italy, Portugal, and Spain. In other versions, the most competitive economies (Germany and Finland) jump ship, and the remainder try to muddle through together, possibly failing and splintering further.

It is not known how sharp a crisis would be caused by a country's leaving the euro. (See text box, "How a European Recession Could Affect U.S. Growth: IHS Global Insight Forecast.") An orderly exit might look most like currency revaluations, as when Greece replaced the second modern drachma with the third modern drachma in 1954, exchanging 1,000 old drachmae for one new drachma. Such a transition is an inconvenience but not a catastrophe.

Regrettably, that is a best-case scenario. Revaluations usually occur when the government wants to close the door on an era of inflation, and people expect stability. However, an exit from the euro would likely be much messier for two reasons.

First, residents may expect less stability outside the euro, not more stability.

Second, residents will initially want to hold on to their euros and may eschew the unproven currency. Greeks have already withdrawn millions of euros from Greek banks, preferring to hold cash or invest in foreign banks, where there is no risk of having their savings forcibly converted into drachmae and less risk of bank failure.

Anders Åslund compares a potential breakup of the euro with the messy breakup of the ruble zone and the divorce of the Czech and Slovak koruna in 1992.[28] Large devaluations

26. "Airbus in America: Designed in Toulouse, Made in Mobile," *The Economist*, July 3, 2012, http://www.economist.com/blogs/schumpeter/2012/07/airbus-america (accessed July 9, 2012).
27. This figure is for total exports, which includes goods imported to the U.S. and then re-exported to Europe. Excluding re-exports, the figure is $241 billion. U.S. International Trade Commission, Interactive Tariff and Trade DataWeb, http://dataweb.usitc.gov/ (accessed September 5, 2012).
28. Anders Åslund, "Why a Breakup of the Euro Area Must Be Avoided: Lessons from Previous Breakups," Peterson Institute for International Economics *Policy Brief* No. PB12-20, August 2012, http://www.iie.com/publications/pb/pb12-20.pdf (accessed September 5, 2012).

have followed currency breakups, both from inflation and from currency runs. In neither case does Åslund find evidence that the devaluation helps to alleviate underlying economic weakness, as some have suggested. While eurozone members may find it desirable or necessary to exit, only fundamental reform, not currency manipulation, can solve the underlying problems.

WHILE EUROZONE MEMBERS MAY FIND IT DESIRABLE OR NECESSARY TO EXIT, ONLY FUNDAMENTAL REFORM, NOT CURRENCY MANIPULATION, CAN SOLVE THE UNDERLYING PROBLEMS.

Uncertain Politics. How European voters will respond to economic distress remains to be seen. In recent Greek elections, communist and neofascist parties together won more than 11 percent of the vote. SYRIZA, a hard-line socialist coalition, vaulted from obscurity to become the second-largest party in Greece with 27 percent of the vote. European voters are not immune to voting for destructive political leaders, and European leaders are not immune to making decisions that harm themselves and their allies.

If Europe suffers a steep economic decline, everything is in play. Some countries might abandon NATO, Eastern European countries could elect Russian-oriented leaders, or anti-immigrant parties might close borders and further curtail religious freedom. Countries that leave the euro for valid reasons might later hyperinflate their currencies to perpetuate high government spending. Instead of cutting subsidies and freeing trade, European leaders could increase subsidies to politically important industries and raise barriers to trade. Any of these actions would harm U.S. interests and diminish European stability.

Inaction on Reform. A country with sound policies can ride out a crisis. For example, Estonia sustained a massive drop in GDP in 2009 and bounced back to strong growth, reelecting the government in the process. However, most European countries lack competitive policies and instead hamper businesses and workers with myriad restrictions. The *Wall Street Journal*'s tour of Italy's restrictions on starting and growing a business illustrates the anti-competitive, anti-growth regulations that plague European labor markets.[29]

In addition to labor rigidities, restrictions like zoning codes, environmental regulations, and agricultural subsidies conspire to reduce investment and raise prices. Europeans have access to the same technologies as Americans, but they produce only 71 percent as much output per person—the same as in the 1980s.[30] With mounting debt and aging populations, Europeans can no longer afford to delay reform. As explained in The Heritage Foundation's primer on sovereign debt, economic growth is the only way to escape debts of this scale.[31] Europe needs growth, but its current policies are preventing it.

Policy Conclusions

In the long run, both the United States and Europe need flexible and competitive policies that free people to pursue their ambitions.

U.S. Policies. The U.S. can best help Europe by pursuing sound economic policies at home. For 2012, this means pulling back from the fiscal cliff by making the 2001 and 2003 tax cuts permanent.[32] Over the next few years, it means reforming entitlements to preserve Medicare and Social Security for the next generation. Just as a strong European economy lifts the United States, a strong U.S. economy lifts Europe.

The U.S. government should encourage Europe's leaders to pursue long-run strategies that will instill confidence. The Obama Administration has actively worked against the best interests of Europeans and Americans by encouraging European leaders to spend money on discredited short-term Keynesian stimulus.[33] Instead, U.S. leaders should highlight the successful American experience with welfare reform and push for trade deals to eliminate costly agricultural and industrial subsidies on both sides of the Atlantic.

29. Op-ed, "Employment, Italian Style," *The Wall Street Journal,* June 25, 2012, http://online.wsj.com/article/SB10001424052702304898704577478111174204768.html (accessed August 21, 2012).
30. World Bank, World Development Indicators, "GDP per Capita, PPP (Constant 2005 International $)," 1980–2011.
31. Salim Furth, "What Debt Crisis? A Default Primer for Governments," Heritage Foundation *Backgrounder* No. 2713, July 24, 2012, http://www.heritage.org/research/reports/2012/07/what-debt-crisis-a-default-primer-for-governments.
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Reforms in Europe. European leaders are focused on building a bridge to the other side of the ongoing crisis. This is a mistake. As bad as the present situation is, the long-term prospects for European growth are even worse. Without a foundation for long-run growth on the other side, no bridge will deliver Europe safely across its current troubles.

The policies that foster long-run growth are well known. Even the European Commission's own economists understand that improving long-run growth will require structural reform.[34] Although the details differ from place to place, leaders in each European country should:

- **Cut** taxes and government spending;
- **End** welfare as Europeans know it;
- **Stop regulating** workplaces so harshly that 10 percent to 30 percent of the economy goes underground;[35]
- **Promote** competition instead of coddling iconic corporations;
- **Allow** employers to fire workers so that they can risk hiring young and inexperienced workers;
- **Liberalize** zoning restrictions in cities, where the high cost of rent pushes workers away from the most productive locations and discourages child-bearing;
- **Encourage** immigration of skilled workers; and
- **End** agricultural subsidies and trade barriers.

Free people working in free markets are the only path to long-term growth and prosperity. If Europe can implement the right policies for the long run, the short run will look a lot shorter and more manageable.

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35. Andreas Buehn and Friedrich Schneider, "Shadow Economies Around the World: Novel Insights, Accepted Knowledge, and New Estimates," *International Tax and Public Finance*, Vol. 19, No. 1 (February 2012), pp. 139–171.