Bloomberg Businessweek

Bloomberg
Monday May 10, 2010

Greek Contagion Myth Masks Real Europe Crisis: Caroline Baum

May 09, 2010, 9:20 PM EDT

Commentary by Caroline Baum

May 10 (Bloomberg) -- Greece sneezes and Portugal catches a cold. Portugal coughs and Spain falls ill. Spain runs a fever and Italy comes down with the flu.

Contagion, or contagion theory, is sweeping the euro zone, where Greece's debt crisis is infecting neighboring countries and threatening to make its way across the Atlantic to U.S. shores.

At least that's what we're told on a daily basis. European Central Bank council member Axel Weber warned last week of "grave contagion effects" for countries that have adopted the euro. "Greece Fuels Fears of Contagion in the U.S.," trumpeted a May 6 Wall Street Journal headline.

I hate to pour cold water on that theory, but healthy countries aren't susceptible to Greece's disease. The sick ones, already plagued with high debt levels and bloated state budgets, don't need a carrier. Capital flight from these countries "is not evidence of contagion," said economist and author Anna Schwartz.

Of course, Schwartz said that in 1998 following the Asian financial crisis. In "International Financial Crises: Myths and Realities" (the Cato Journal, Vol. 17 No. 3), Schwartz punctured the notion that financial crises spread from the initial source to innocent victims. Nations are vulnerable because of their "home grown economic problems," she said.

Schwartz's insights are equally valid today. Capital isn't fleeing sovereign debt markets in Spain and Portugal because Greece can't pay its bills. Bond yields are rising because of an increased risk those countries may find themselves in the same boat as Greece: unable meet their debt obligations.

Chronic Defaulter

OK, maybe not quite as leaky a boat. It would be hard to match Greece's record of spending half the years since its independence in 1829 in default or rescheduling its debt, according to economists Carmen Reinhart and Ken Rogoff, authors of "This Time is Different."

A single currency, it turns out, isn't a panacea for everything that ails Europe. The 11 nations that scrapped their sovereign currencies and adopted the euro in 1999 never constituted an optimum currency area as envisioned by economist and Nobel Laureate Robert Mundell, the father of the euro.

"They don't have a mechanism to deal with crises when they come up," says Michael Bordo, professor of economics at Rutgers University and author of a book on the history of monetary unions. Europeans knew if they ceded domestic monetary policy to a centralized European Central Bank they would need "labor mobility and/or transfers from healthy states to weaker ones to deal with asymmetric shocks," he says.

Fiscal Transfers

Europe has neither. Political union is still a dream. Germans are still Germans, and Greeks are still Greeks. The man on the street in Dusseldorf probably doesn't understand why the German government has to fork over what could be his pension to a country for whom default is a way of life.

Political union isn't a prerequisite for dealing with a sovereign debt crisis. What's needed is some kind of a priori agreement on how fiscal transfers are to be carried out, says William White, chairman of the Economic Development and Review Committee at the Organization for Economic Cooperation and Development. In the case of the euro zone, "they were short of a few fiscal elements," he says.

It's far from clear the German public would have supported such transfers from strong to weak countries, White says. Especially if it's the same profligate nations, such as Greece, that keep feeding at the trough.

Wake-Up Call

That said, European leaders have invested too much political capital in a united Europe to turn back now. Germany's Parliament approved a package of loans to Greece on Friday, part of a 110 billion euro ($142 billion) package from the International Monetary Fund and European Union. Greece approved an austerity plan in exchange for the bailout.

"This should be a wake-up call to design mechanisms to deal with crises and enforce the rules" on debt and deficits, Bordo says.

The 1992 Maastricht Treaty outlined four convergence criteria for joining the European Monetary Union, including a maximum deficit-to-GDP ratio of 3 percent and debt-to-GDP of 60 percent. Last year Greece's deficit and debt were 13.6 percent and 115 percent, respectively, as a share of the economy. All of the infected countries, and a few that haven't caught the disease yet, are well in excess of those limits. The U.K., for instance, which is benefiting from capital flight out of Europe's Club Med countries, ran a deficit last year that was 11.5 percent of GDP.

Investors may flee the U.K. at some point, but it won't be because it caught anything from Greece.

Incubation Period

There is no question we live in an interconnected world. Subprime mortgage defaults by homeowners in Irvine, California, infected banks in Europe and Asia, thanks to the miracle of securitization.

So yes, European banks that hold Greek debt are vulnerable to losses. The interbank lending market is showing signs of stress. And the austerity measures required in Europe's peripheral countries may spill over into reduced U.S. exports. That's not the kind of contagion we keep hearing about.

On the other hand, it would be a mistake to interpret the flight-to-quality into U.S. Treasuries last week as a sign of immunity. The U.S. is already infected with the debt virus. It's still in its incubation period.

--Editors: Steve Dickson

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