THE GEORGE WASHINGTON UNIVERSITY
SCHOOL OF BUSINESS

Number 28
September 2011

ECONOMIC VIEWPOINT

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Europe's Avoidable Policy Mistakes: Learning from Experience

One cannot help but wonder whether Europe's policy-makers have internalized any of the lessons from developing and emerging economies that have faced macro-financial difficulties in the past. If they had learned some of these valuable lessons, the cost of the current bailout of EU members and the likely duration of the associated economic and political pain could have been shortened.

What do finance ministers in developing market economies learn early on? The first lesson is that you cannot jawbone markets into believing in your currency or the value of government paper when fundamentals argue otherwise. In crisis after crisis, whether in Thailand or Argentina or smaller countries, the notion that markets can be either cajoled or persuaded to buck a declining trend has been disproven. Hence, the repeated actions of European policy-makers, telling markets that they are charging too much for the bonds of weaker members, have fallen flat. You simply cannot use rhetoric to persuade markets to reverse course.

A second fundamental lesson that finance ministers in the "Third World" learn very quickly is that delay in adjusting the economy merely adds to the ultimate cost. In the case of Europe, the delay is seen in relation to the inevitable write-down of debt. The cost to the EU of the current crisis has increased over the last year, and the EU has continually needed to augment its bailout resources. Related to this admonition that the European Central Bank and others have steadfastly resisted is the policy lemma that central banks not purchase impaired assets at face value. Trying to reverse expectations by buying government debt at par means that the ultimate debt restructuring will be more of a public loss allocation than one involving market participants. The government's bill continues to rise.

The third lesson is that fiscal discipline without economic growth is as dangerous as unbridling growth without discipline. The two go hand in hand. Countries that cut deficits but had no growth strategy became the poster children for poor IMF-led adjustment programs. Others that steered a reckless fiscal course ultimately had to deal with their profligacy. So, too, in the case of Greece, and now Portugal and Spain, the notion that debt-to-GDP ratios can be fundamentally realigned without restoring economic growth has been shown to fail. In the case of the Eurozone, without an exchange rate to realign or monetary policy to put in play, the fiscal retrenchment (especially with relatively rigid labor markets) has meant that southern Europe is left without policy instruments to promote economic growth.

What makes the European drama so surprising is that officials have failed at each opportunity to take the right decision. Moreover, incremental policy measures that never got ahead of the problem have produced a far higher ultimate cost, as the IMF surely could have predicted. Odd, as well, is the fact that these policy mistakes have been learned at a high price in much of the developing and emerging market world, yet these same lessons apparently have eluded the European establishment.

Some will argue that this is due to domestic politics, especially in Germany and other surplus countries of the Eurozone; others will insist that it reflects the new role being forced upon the European Central Bank and its reluctance to accept that role. Whatever circumstances face Europe, its situation is not sufficiently unique to vitiate the lessons of policy-makers around the world who have dealt with similar, if not identical, dilemmas. In a world in which the rich countries are often prone to lecture the poorer countries, this lack of knowledge transfer is all the more remarkable, lamentable and costly. ■

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