Euro crisis: Major belt tightening needed

By Joseph Cherian and Bernard Yeung

Can the European sovereign debt crisis derail the global economic recovery?

The global financial crisis that began some time in 2007 was chiefly triggered by consumers in the United States. An overleveraged household balance sheet, caused by consumers spending beyond their means on homes using easily available credit, resulted in a housing bubble that eventually burst. Likewise, unscrupulous overleveraging among banks allegedly corrupted the financial system.

The European sovereign debt crisis has similar underpinnings. Sovereign debt levels in some euro zone countries – particularly Greece, Portugal, Ireland, Spain and Italy – rose substantially. Governments overspent because of their access to easy financing via membership in the euro zone. This eventually led to a crisis of confidence and the widening of sovereign yields and credit default swap spreads in these countries.

This problem could be systemic among advanced economies. Many governments are into high levels of indebtedness. They borrow to finance spending so as to stimulate their economies. The end result is risky high government indebtedness. Postponing the obvious – after all, yesterday's overspending has to be matched by lower consumption and income at some point in the future – cannot be credible for long.

As Kenneth Rogoff and Carmen Reinhart pointed out in their book, This Time Is Different: Eight Centuries Of Financial Folly, excessive leverage, whether by private or sovereign entities, leads to much greater systemic risks during the downturns than was anticipated during the boom times.

To the optimists who claim that the European debt peril is a manageable one, our appeal is simple: Think again. As in the US crisis, a general lack of confidence in the financial system can easily lead to contagion and collapse. The combined foreign debt of Spain, Portugal, Italy and Greece amounts to US$2.5 trillion (S$3.5 trillion), about the level of their combined gross domestic product. In addition, there is a debt time bomb among former Eastern European countries too.

If creditors cut off funding to these highly indebted nations, we could witness a euro zone financial crisis resembling the 1997 to 1998 Asian financial crisis. Indeed, the European crisis could dwarf the Asian one.

Until recently, banks were depositing a record level of overnight deposits with the European Central Bank (ECB). This unprecedented level of deposits, not seen since the euro commenced life in 1999, bears a striking resemblance to the drying up of credit in the US during the early days of the crisis from 2008 to last year.

The best way to handle a crisis is to first acknowledge that there is one. The ECB’s recent proclamation that the euro zone’s financial sector and economy are facing “hazardous” contagion effects is a step in the right direction. European financial institutions, which already took a major balance sheet beating during the last global crisis, are expected to go through another round of large write-downs and this time, possibly without the same emergency financial support and bailouts that governments offered during the previous round.

In these circumstances, eloquent talk of fiscal austerity, new-found tax revenue or structural reform will not be sufficient. A major tightening of the fiscal belt is required in the euro zone, and that has to be recognised by the public.

Despite the large volume of trade between Europe and Asia, we don’t think the European sovereign debt crisis will have any more impact on Asia than the US-led global financial crisis did. We can nevertheless help further insulate ourselves from American and European economic and financial crises, albeit without being protectionist.

We can do so by increasing Asian consumption and intra-Asian trade, by exercising fiscal prudence at all times, by arresting credit and asset bubbles, and by mitigating regional geopolitical risks while simultaneously conducting good faith multilateral cooperation within Asia. There is still ample room for Asian countries to cooperate on trade, human capital development, the environment, education, travel and finance.

Asia’s best years are yet to come. A stable economic and political environment, a competitive and highly educated workforce, consistent business-friendly policies and good faith cooperation will certainly get us there faster. Most importantly, Asian self-reliance is the key to our economic future.

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