Strong EU economy promotes strong security

Greek economic crisis sparks international cooperation

Greece's financial crisis, coming after the 2009 global downturn, has Europeans asking whether the economic system that has served them for decades is sturdy enough to carry them prosperously into the future. Greek fiscal mismanagement has raised questions not only about the sustainability of cradle-to-grave welfare states in which healthy adults can retire in their early 60s, but also about the very survival of the eurozone among a smorgasbord of nations with radically different ideas about debt and spending.

Europe is not the only part of the world running deficits, but its shrinking native population, absent brisk immigration, affords it less flexibility. Free-market economists argue that lavish domestic programs crowd out spending on international aid and military modernization and stymie economic growth that could create jobs.

So what's the answer? European Union economists and political leaders are considering three fundamental reforms they hope will prevent future crises that threaten the EU's health and stability. Facing opposition at every turn, none of the reforms will come easy:

- Revise the social contract in EU member states so that pensions, unemployment insurance and taxation don't undermine the very economic vitality on which the EU depends. Sweden, for example, has partly privatized its national retirement system using a Chilean free-market model that provides higher returns with less government involvement.
- Increase regulation of a banking system blamed for nearly collapsing Western economies in 2008 and 2009. Proposals have included a new international tax on banks and demands that lenders across Europe hold larger reserves to act as cushions against bad loans.
- Create a European Monetary Fund that would mimic the International Monetary Fund's bailout capabilities. The IMF makes emergency loans aimed at stabilizing nations in financial trouble. An EMF could do the same for EU member states, building upon the 750 billion euro stabilization fund the EU created in May to address the Greek crisis.

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An elderly man feeds seagulls in downtown Stockholm. Sweden's pension system is seen as a sound economic model for other nations to follow.

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Greek police guard a bank during a protest in Athens, Greece, in April 2010.

When it comes to imposing fiscal discipline, Europe might not have the luxury of choice. Through much of 2010, the IMF has warned that investors who have propped up Greece and other EU countries by buying its bonds are losing patience. In a global economy, that means cash might flee to emerging economies such as those in India, China and Brazil, where up-and-coming markets can offer higher returns on investment. The IMF, for example, predicts economic growth in the EU in 2010 will be less than half the average of the other advanced nations and only one-quarter the world average. What's new — and troubling for the EU — is that investors may view non-European economies as lower risk.

"The world is still a dangerous place, and I don't like that many people have in mind that the crisis is over, that everything is behind us, and we can go back to business as usual," IMF Managing Director Dominique Strauss-Kahn said in April 2010 during the release of the organization's twice-annual World Economic Outlook.

With aging populations and declining birthrates, many EU nations do not collect the taxes needed to finance government spending. Economists often single out Portugal, Spain and Italy in that regard. Greece is a good example of how such a debt crisis can potentially tie a nation's hands militarily. Before the debt crisis, Greece made the largest contribution to Europe's defense relative to the size of its economy, NATO reported in February 2009. The nation spent 2.8 percent of its gross domestic product on defense in 2008, the last year for which data is reliable. That was much higher than the 1.7 percent of GDP average defense budget for NATO's other European members.

"European economies face a classic free-rider problem. Domestic fiscal profligacy — public spending beyond the nation's willingness to pay — generates short-term domestic benefits but also long-term costs that are shifted to all other eurozone members. The Greeks pushed the envelope in playing this game to the detriment of its European partners," the free-market think tank the Cato Institute said. "But other major European countries also face prospects of rising budget deficits because of their generous social insurance programs and aging populations. Thus, Spain, France, Germany, Portugal, Italy and other EU nations must also introduce fiscal consolidations — mainly spending reductions in pension, health, welfare and other government programs because European tax rates are already very high. Without such adjustments rising budget deficits would signal higher inflation risks and erode international credibility in the newly created euro as a secure currency."

Some Europeans are turning to Sweden as a model. Once the poster child for socially conscious welfare states, Sweden has mandated semiprivate individual retirement accounts based on an unlikely model: a Latin American private pension system first developed in 1980 by former Chilean Labor Minister José Piñera. While the Swedish pension system still subsidizes the poor and protects older workers, the free-market reform is expected to save the nation's 9.2 million people billions of euros, the Swedish government estimates. Greece could learn a lesson from its EU partner to the far north.

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A Greek riot policeman stands in front of graffiti written on the wall of a bank during violent demonstrations over austerity measures in Athens, in May 2010.

REUTERS

Because of higher life-expectancy rates, Greek retirees collect pensions for twice as many years as they did in the 1960s. A Greek worker can expect to spend more than a third of his adult life living off the largesse of his fellow taxpayers. Some Hellenic retirees earned more after retirement than when they worked, the Organization for Economic Co-operation and Development noted. Nevertheless, change won't come easy. Greek government workers have strongly protested, even rioted, against suggestions by Prime Minister George Papandreou to raise the nation's average retirement age from 61 to 63, cut salaries and trim the government work force.

The historic downturn has also drawn attention to rash lending by banks that helped collapse home prices in the United States and much of Europe, most notably on Spain's Costa del Sol. For international and European banks that relied on mortgages for much of their profits, the housing plunge has driven many to the edge of ruin. Deutsche Bank, for example, reported losing billions of euros after U.S. and European housing loans defaulted.

According to some EU members and the IMF, obvious reforms involve regulations, binding on both sides of the Atlantic, to boost banks' capital requirements. The goal is to maintain sufficient reserves should borrowers default en masse. The IMF has also suggested internationally binding banking taxes, a plan backed by German Chancellor Angela Merkel. If the tax is limited to just a few countries, IMF officials fear banks will move offshore to avoid paying the tax. Aside from a proposed flat levee, they said a second tax would be

Thousands of Greek demonstrators march through central Athens during a protest marking a 24-hour general strike against government austerity measures in May 2010.

scaled to the riskiness of a bank's lending. The more secure deposits a bank held, for example, the smaller the tax burden.

Policymakers must tread carefully, the British Bankers' Association cautioned. European bankers loath the tax idea and argue over what size cash reserves should be. They complain the tax could reduce profits by 15 to 20 percent, a reduction they could pass on to consumers through higher lending rates and fees. Unlike in the U.S., where companies can tap a large corporate bond market, European businesses finance expansions mostly through bank loans. So bank reform could raise the cost of doing business in Europe.

"The effect of such schemes is to hold up bank lending. This is because such levies cut into the profits of banks and prevent them restoring their reserves. This is at a time when politicians are screaming at the banks to do the reverse," said Miles Saltiel of the Adam Smith Institute, a London-based free-market think tank.

The Greek debt crisis exposed a flaw in the European monetary system. The European Central Bank, focused on its main role of suppressing inflation, lacks bailout power comparable to that of the U.S. Federal Reserve. This situation led some experts to suggest the creation of a European Monetary Fund modeled on the International Monetary Fund. The IMF controls hundreds of billions of dollars donated by member states, money that acts as emergency cash to financially strapped nations.

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An elderly couple shop in the Athens central market in May 2010. Economic reforms in Greece that might include cutting pensions and raising the average retirement age have sparked violent protests.

Free-market economists such as those at the Adam Smith Institute have been critical of most IMF interventions and have extended that criticism to the EMF proposal. Leniency can lead to laxness, they say. By bailing out spendthrift countries, the organization encourages more such free-spending behavior in the future. What's more, economists point to cases where IMF support failed to lead to sustained improvement in recipient nations' economies.

Another hurdle: The Maastricht Treaty, the 1992 accord that established the euro as common currency, includes a "no bail-out" provision critics contend an EMF would violate. Still, economists such as Deutsche Bank's Thomas Mayer believe a well-crafted EMF could provide the needed stability without the "moral hazard" that comes with bailing out irresponsible spenders. "Without such an institution, a country like Germany would always find itself in a 'lose-lose' situation if a country like Greece is on the brink of collapse," Mayer said in a February 2010 report for the Centre for European Policy. "If Germany agrees to a rescue package, it puts its public finances at risk. If it does not, its financial institutions would bear the brunt of the considerable losses that would arise from a disorderly failure and the ensuing contagion."

A growing number of EU leaders are recognizing that underperforming economies often struggle to find money to provide for common defense, let alone generate enough jobs. The Greek crisis is making that clear. Changing established practices, including the lavish endowment of pensions for the EU's rapidly aging populations, will take years.

The European defense establishment also recognizes the danger. In March 2010, NATO Secretary-General Anders Fogh Rasmussen, a Dane, warned member states against solving their debt problems at the expense of needed military modernization. "The Lisbon Treaty provides the EU with a stronger defense and security policy dimension," Rasmussen announced in April 2010. "But this will remain a paper tiger if it is not followed up by concrete military contributions when we need military contributions."

Many EU nations promised in January 2010 to continue supporting global military missions such as the International Security Assistance Force in Afghanistan. The London-based International Institute for Strategic Studies reported in February 2010 that EU military spending rose through 2008. But the institute warned of "drastic" NATO defense cuts starting in 2010 if the global, and Greek, economic woes continue. □