James Bullard, President and CEO
Federal Reserve Bank of St. Louis

The European Debt Crisis: Lessons for the U.S.

Recently the key concern in world financial markets has been the extent to which the sovereign debt crisis in Europe portends a global shock, possibly strong enough to upset the global recovery.

There is no question that, in part as a response to the events of 2008 and 2009, many governments in Europe and elsewhere elected to increase deficit spending and thus to increase their debt as a percentage of GDP. For some countries, starting from weak economic conditions, the increase in borrowing was so large as to call into question their ability and willingness to repay in international financial markets. Confidence lost in such markets is difficult to regain, and for this reason I think we can expect market concerns to remain for months, possibly years, rather than just days or weeks. Governments must take aggressive action to earn credibility, and then sustain that effort over a long period of time. I think that a well-run fiscal consolidation can be a net plus for economic growth, as it was in the U.S. during the 1990s.

To be sure, sovereign debt crises are not at all unusual in the history of the global economy. Nations often have incentives to borrow internationally and are not always willing to repay. Over the past 200 years, there have been at least 250 cases of a government defaulting in whole or in part on its external debt. While sovereign debt restructuring or outright default is often associated with substantial market volatility—understandably, since some parties are not getting repaid—the events are not normally global recession triggers. A relatively recent and prominent example was the Russian default of 1998.

The agreement in Europe to provide funding if necessary through a Special Purpose Vehicle backed by government guarantees and through the IMF has provided time for the affected countries to enact fiscal retrenchment programs. Those programs have a good chance of success because the incentive for countries to keep unfettered access to international financial markets is substantial. Even if a fiscal consolidation program does not go well in a particular country, so that a restructuring of debt has to be attempted at some point in the future, restructuring is not unusual in global financial markets and can be accomplished without significant disruptions.

"Now that the U.S. economy is about to achieve recovery in GDP terms, it is time for fiscal consolidation in the U.S."

One of the persistent worries during this crisis has been that some of the largest financial institutions in the U.S. and Europe might be exposed to additional losses and that a type of financial contagion could occur should conditions worsen. I think this is a misreading of the events of the past two years. U.S. and European policymakers have essentially guaranteed the largest financial institutions. This has been the essence of the very controversial "too big to fail" policy. The policy has clear problems, including its inherent unfairness and the fact that economic incentives for institutions that are guaranteed can be badly distorted. But to argue that governments would now give up these guarantees in the face of a new shock that could threaten the global economy seems to me to be far-fetched.

One important lesson from the European sovereign debt crisis, well-known in emerging markets, is that borrowing on international markets is a delicate matter. There can be benefits of such borrowing in some circumstances, but too much can erode credibility and lead to a crisis in the borrowing country. In short, countries cannot expect to borrow internationally and use the proceeds to spend their way to prosperity.

The U.S. fiscal situation is difficult as well, with high deficits and a growing debt-to-GDP ratio. The U.S. has exemplary credibility in international financial markets, built up over many years. Now that the U.S. economy is about to achieve recovery in GDP terms, it is time for fiscal consolidation in the U.S. Irresponsibly high deficit and debt levels are not helping the U.S. economy and could damage future prospects through a loss of credibility internationally. Ω