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Learning from the US experience?

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Greece is now clearly on the brink of default. Should one regard as unthinkable that its fellow eurozone member countries would allow this to happen? The early history of the United States provides an interesting pointer given that the federal budget at that time was as small as the EU budget is today.

Shortly after the end of the American war of independence, the US Treasury assumed the $21 million in debt (a large sum at that time) that had been accumulated by the 13 founding states. The states hardest hit were those without major harbours, which deprived them of the revenues that coastal states could earn from the duties imposed on overseas trade. In a scheme devised by the first US Secretary of the Treasury, Alexander Hamilton, the federal government assumed all of this debt in 1790. Today, many proponents of ‘euro bonds’, i.e. bonds issued by a common euro area authority; point to the US experience as a useful example to follow.

The reaction of the US authorities was radically different about fifty years later, however, when in the 1840s the federal government stood by and allowed a number of states to fail. The explanation lies in the different sets of historical circumstances leading to the US states’ insolvency: the American Revolutionary War was a collective national effort to defeat Great Britain and the expenditures by the individual states went to finance this common goal, thereby providing a strong argument for the federal government to take over the debts. In the latter case, however, the debts had been contracted by the states to finance what were clearly home-grown, local projects, for example banks and railroads, aimed at advancing internal state interests.

It is also interesting to note that this latter set of defaults involved nine (mostly newer) states accounting for about one-quarter of the total population of the US and would thus be comparable to a collective default by Greece, Portugal, Ireland and Spain together. What’s especially interesting about this episode in US economic history, however, is that no widespread contagion ensued. We can thus conclude that a default within a federation does not have to trigger catastrophic political consequences.

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