Mitchell’s Musings 7-6-15: Lessons for the Greek Crisis from What Didn’t Happen in California

Daniel J.B. Mitchell

From time to time in these musings, I have referred to a paper I wrote back in 1998 – before the Eurozone was fully in place – entitled “Eur-Only as Sovereign as Your Money: California's Lessons for the European Union.”¹ The paper appeared in the June 1998 edition of the UCLA Anderson Business Forecast publication as an excerpt from a longer presentation I made subsequently at a meeting of an international group that took place in Bologna. The theme of the paper – as the title suggests – was that countries joining the Euro-zone were giving up an important element of their macroeconomic policy.

Specifically, countries joining the Euro-zone were surrendering their conventional monetary policy (control of interest rates) and the ability to change their exchange rate, i.e., to vary their competitive costs of production, relative to those of their major trading partners. In recompense for that loss of control, those countries that joined would get lower cross-border transactions costs and an end to exchange rate risk with other countries within the Euro-zone. So was the upcoming sacrifice worth the benefit? That was the key question and it seemed to me at the time that there was insufficient recognition of the trade-off prospective Eurozone members were facing.

The paper noted that the State of California was effectively a member of the “dollar-zone” within the U.S. Thus, while benefiting from lower transactions costs and an absence of exchange rate risk with the rest of the U.S., California had no independent state monetary policy. Put another way, California’s monetary policy was effectively in the hands of an external Federal Reserve, the U.S. central bank. And when California experienced a negative shock – the end of the Cold War around 1990 and the resultant decline of its then-large aerospace/military industry – it could not change its exchange rate to facilitate the adjustment relative to the other areas of the U.S.

There were two results of this lack of economic sovereignty in California. A mild recession in the U.S. in the early 1990s could not be escaped by California since it was part of the overall dollar-zone. And the structural negative shock (end of the Cold War) played out as an ongoing state budget crisis, a decline in employment, an out-migration of those workers displaced by the shock, etc. Californians who were around at that time will recall those developments and adjustments as painful.

Californians might also recall something else that happened in the aftermath of the downturn of the early 1990s. Just as the state government was adversely affected by the economic shock

¹http://www.anderson.ucla.edu/documents/areas/fac/hrob/Mitchell_Eur-Only.pdf
(reduced tax revenue), so, too, were local governments within California. One of those local governments, Orange County – located just south of Los Angeles – went into bankruptcy in late 1994.²

There is an old joke that you can find out who is swimming naked only when the water recedes. It turned out that Orange County had been engaged in financial speculations which, for a time, provided high returns on investment that helped sustain local services by supplementing tax revenues. But with high returns inevitably comes risk. And one day the economic tides receded and there were big losses rather than high returns for Orange County. The County’s financial misbehavior was exposed and it could not pay all its bills. Some creditors would not be paid on schedule.

As are the other counties in California, Orange County is run by an elected Board of Supervisors.³ In 1995, the Board put a proposition on the County ballot asking voters whether they wanted to raise the local sales tax to maintain services and avert bankruptcy-related cuts. The tax was rejected by the electorate. And after some missed debt payments, arrangements were worked out with creditors and eventually the County recovered. There is more to the story, but now you have the general outline.⁴

The article I referred to at the outset of this musing drew lessons for the impending Euro-zone from what happened at the state level in California in the 1990s. But there are also lessons from what didn’t happen at the local level in California for the current Greek crisis. But let’s start with what did happen. The private sector in Orange County continued its recovery from the larger California recession that developed earlier in the decade as can be seen on the chart below.

Having an unstable local government that was in financial difficulties was certainly not a plus for the County’s business climate. But those difficulties didn’t create a local recession, either. In particular, there were no financial panics. There were no runs on banks in Orange County. County residents had full access to their bank accounts. They didn’t empty grocery store shelves and hoard food. They didn’t hoard currency. ATMs operated normally. Residents’ credit cards continued to be accepted. Stock markets in the U.S. and around the world did not tremble because Orange County’s government couldn’t pay all its bills.

²Orange County at the time had a population of about two and a half million people. Its population today is over three million and it has a gross product of over $200 billion. See http://www.fullerton.edu/cdr/ocff.pdf. In dollar terms, that gross product is roughly comparable with Greece’s.
³Counties in California’s complicated hierarchy of governments provide health and welfare services, run local jails, and provide services such as police and fire in unincorporated areas (areas that are not part of cities) and in cities that contract with the county of such services.
⁴See http://www.ppic.org/content/pubs/op/op_398op.pdf
Now imagine a very different scenario. Suppose the Federal Reserve had declared in 1994 that if Orange County’s government couldn’t or wouldn’t pay all its debts, the Fed would stop providing the ongoing backup to banks in Orange County that central banks typically provide. Suppose that the Fed had announced that if Orange County’s government could not pay its debts, the County could no longer even be in the dollar-zone and therefore the County would have to introduce its own currency or somehow cope on its own. Clearly, there would have been a more drastic fallout from the Orange County bankruptcy than actually occurred if any such announcement had been made. Surely, there would have been runs on Orange County banks. Since those banks are connected to financial institutions outside Orange County, the panic could easily have spread nationally and even internationally.

But none of these things happened. In fact, it is unthinkable that the Fed or other central government institutions in the U.S. would take such a position. They simply wouldn’t say that because a local government within the dollar-zone was not meeting its obligations to creditors, all central obligations to maintain financial and general economic stability within that jurisdiction’s private sector would cease. They wouldn’t say that the local jurisdiction would have to create its own currency thereafter. Instead, they would view the residents,
banks, and businesses of areas within the dollar-zone as remaining in it, regardless of what their local government authorities might do.

Indeed, anyone reading this musing would say that my hypothetical story above is ridiculous — because it is ridiculous. I have no idea how the Greek electorate will vote on the planned referendum on the Eurozone’s terms. I have no idea what the Greek government may do. And it really doesn’t matter for the purpose of this musing. If the story above seems ridiculous as a policy for U.S. central authorities to have followed in Orange County’s government debacle, why isn’t it a ridiculous policy for Euro-zone central authorities to be following in the Greek debacle?

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5Although this musing is dated the day after the planned referendum, it was written before. Mitchell’s Musings are typically dated the Monday of the week in which they appear.