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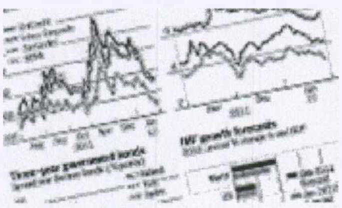
Europe is stuck on life support

By Martin Wolf

Economic decision-makers are more optimistic than two months ago. The main reason is the belief that the European Central Bank, under the shrewd leadership of Mario Draghi, has eliminated the risk of a financial implosion in the eurozone. As Mark Carney, the respected governor of the Bank of Canada and Mr Draghi's successor at the Financial Stability Board, remarked at the World Economic Forum in Davos: "There is not going to be a Lehman-style event in Europe. That matters."

Spreads on credit default swaps on Italian and Spanish banks have fallen since the introduction of the ECB's three-year long-term refinancing operations in December. Spreads between yields on debt of some vulnerable sovereigns and German Bunds have also eased.



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Does this mean the eurozone crisis is over? Absolutely not. The ECB has saved the eurozone from a heart attack. But its members face a long convalescence, made worse by the insistence that fiscal starvation is the right remedy for feeble patients.

Last week's downgrading of its forecasts by the International Monetary Fund shows the dangers. The IMF now forecasts a recession in the eurozone this year, with a decline of 0.5 per cent in overall gross domestic product. GDP is forecast to fall sharply in Italy and Spain, and stagnate in France and Germany. This is a terrible environment for countries seeking to cut fiscal deficits. Forecasts are far from satisfactory for other high-income countries. But the eurozone is the most dangerous part of the world economy: only there do we see important governments – Italy and Spain – menaced by a loss of creditworthiness.

Elsewhere, governments of high-income countries can continue to support their economies, largely because they possess a central bank and an adjustable exchange rate. This combination has given them the ability to run large fiscal deficits. In post-crisis conditions, such deficits are both the natural counterpart and the principal facilitator of necessary private sector deleveraging.

The eurozone has no such internal mechanisms. When private external financing dried up, as happened to a number of countries, affected members needed both financing – in the short run – and a mechanism for adjusting their external accounts – in the longer run – other than via deep slumps. The eurozone lacks both capacities. It has turned out, as a result, to have limited ability to cope with the global financial disease. As Donald Tsang, chief executive of Hong Kong, remarked in Davos: "I have never been as scared as I am now." Astute observers have a sense that little stands between them and a wave of sovereign and banking defaults inside the eurozone, with ghastly global repercussions.

The ECB has reduced the risk of an immediate collapse of the banking sector. But the demand of informed outsiders is for stronger firewalls against the possibility that a collapse of, say, Greece, perhaps including its exit from the eurozone, would lead to a panic over prospects for far more important countries. Christine Lagarde, managing director of the International Monetary Fund, made that one of her three imperatives, along with stronger growth and deeper integration, in a courageous speech in Berlin last week.

What these outsiders want to see is a commitment that vulnerable eurozone countries will be given the time and the treatment they need to recover. Naturally, they also want to see a commitment of resources by the eurozone that makes clear the determination of its members to secure this outcome. Only then would it make sense for an enhanced IMF to add its own contribution. Why indeed should a relatively poor country, such as China, be expected to contribute to rescuing a eurozone that has shown little will or ability to heal itself?

Alas, the problem is not just one of will. It is one of a lack of a correct diagnosis. This is a problem the ECB cannot correct. Germany, as creditor country, opposes a “transfer union” and insists that fiscal discipline is everything. It is right on the first point and wrong on the second.

A long-term transfer of resources to uncompetitive members would be a disaster, enfeebling recipients and bankrupting providers. But fiscal indiscipline is not all. Just as it was not the dominant cause of the collapse, but rather sloppy lending and improvident private borrowing, so fiscal discipline is not the cure. This attempt to vindicate the catastrophic austerity of Heinrich Brüning, German chancellor in 1930-1932, is horrifying.

The perspective embodied in the fiscal compact – itself an attempt to revive the failed stability and growth pact – lacks the necessary understanding of the dependence of output in one member country on demand in others, of the role of payments imbalances and of the fact that competitiveness is always relative. If Italy and Spain are to become more competitive within the eurozone then Germany or the Netherlands must become less so.

Moreover, if the private sector is running a structural financial surplus to lower its debt, policymakers can eliminate structural fiscal deficits if and only if the country runs a structural current account surplus. Germany should understand this because that is precisely what it is doing. Countries hit by financial crises almost always have large structural private sector financial surpluses. If these countries are indeed to eliminate structural fiscal deficits, they, too, must run structural current account surpluses, just like Germany. Yet every country cannot run such surpluses, unless the eurozone as a whole is to do so.

It is impossible for individual countries to heal without offsetting changes elsewhere. As Ms Lagarde said in Berlin: “Resorting to across-the-board, across-the-continent, budgetary cuts will only add to recessionary pressures.” Fiscal tightening must be selective. More important, the indication that the adjustment process is working – so making unnecessary the long-term fiscal transfers Germany rightly detests – would be buoyant demand in the core of the eurozone, with inflation well above the eurozone average – a mirror image of what happened before the crisis.

The strongest note of optimism on the eurozone I heard in Davos rested on the dire results of a break-up. Yet desperate people do desperate deeds. Members now need the time and the opportunity to adjust. Strong firewalls should give the time, but only shifts in competitiveness will give the opportunity. Without both, the crisis will surely return.