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The worst of the euro crisis is yet to come

By Wolfgang Münchau

The most disturbing aspect about the eurozone right now is that every crisis resolution strategy depends on a moderately strong economic recovery. The Greek programme was already in trouble when it was agreed six weeks ago. All the official forecasts were wrong. The country is in a depression, and its debt dynamic is "out of control", according to its new fiscal council. In Italy, the central bank expressed concern that the country's austerity programme would have recessionary effects.

The European bank recapitalisation strategy – if you want to call it that – is also collapsing under the weight of the economic downturn. Last week saw a heated dispute between the International Monetary Fund and the eurozone governments over how much banks need to be recapitalised. The final figure for recapitalisation could be far higher than even the IMF's estimates if the economy plunges back to recession..

The downturn began this summer, and appears to have gained momentum. Bank lending to the private sector has fallen for two months. Broad money supply is well below the reference rate. A widely followed purchasing managers' survey points towards a decline in manufacturing activity in August. For all we know, the eurozone may already be in a recession right now.

The first, second and third priorities of European economic policy should be to stop and reverse the downturn. If they fail to achieve that, the eurozone's crisis will end in catastrophe because every single resolution programme will be in danger of failing. Unfortunately, economic policy is utterly unprepared for an economic downturn. The European Central Bank has been tightening monetary policy since the spring. Fiscal policy is contracting as governments rush to announce austerity programmes. Policymakers seem in no hurry to fix the problem.

Monetary policy is the most important tool at this stage because the ECB has the greatest room for manoeuvre. Inflation expectations have subsided. My favourite market-based measure is zero-coupon inflation swaps. They now point towards an undershoot of the ECB's inflation target. The central bank no longer has an excuse not to cut its main refinancing rate back to 1 per cent, or possibly even lower. The goal should be to ensure that the overnight money market rate converges towards zero. It is now close to 1 per cent, so the effective scope for an interest rate reduction at the short end is close to a full percentage point.

The gap between eurozone and US interest rates is particularly wide a little further down the maturity curve. Eurozone one-year money market rates are now 2.1 per cent, as compared to 0.8 per cent in the US. This is a huge gap, which European monetary policy should seek to close. None of this can stop the downturn on its own, but it would help.

In addition, the ECB should also consider acting on longer-term interest rates. Its present Securities Market Programme is designed as a crisis response instrument – ostensibly to ensure that monetary policy can function. But no one ever believed that argument. There is, however, a way to render it true. The ECB could transform the SMP into a macroeconomic stability programme. For that, it would have to increase the size of the SMP significantly, to a good multiple of the present €115bn. This would be a highly effectively way to prevent the economy falling into a liquidity trap, a position when monetary policy loses traction.

How about fiscal policy? The very least one should expect is for the eurozone to abandon all austerity programmes with immediate effect and to return to a fiscally neutral stance, allowing the automatic stabilisers to kick in fully. At present, such a shift is not even on the agenda. As is so typical in the eurozone, each country behaves like a small open economy at the edge of the world. Each assumes its actions have no impact on the others.

But when France, Spain and Italy all contract their fiscal position at the same time, in addition to Greece, Portugal and Ireland, the result is a co-ordinated fiscal retrenchment of the eurozone. While some of these countries have a fiscal problem, the eurozone as a whole does not. The ratio of its debt to gross domestic product is lower than that of the US, the UK, or Japan. If the eurozone had already moved to a fiscal union some years ago, its finance minister would now be in a position to take action and co-ordinate. Instead, the present system of uncoordinated policies gives us contagious austerity with a contagious downturn.

For as long as there is no fiscal union, the eurozone member states have no alternative but to co-ordinate among each other. I would personally go all the way, and advocate a discretionary fiscal stimulus in Germany, the Netherlands and Finland to offset austerity in the south. What matters is the fiscal stance for the eurozone as a whole. There is, as yet, little recognition in the eurozone's cacophonous capitals that an economic downturn poses an existential threat. I would expect therefore that the downturn will hit the eurozone with full force, and without defence. When that happens, the eurozone crisis will turn ugly.

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