Biting the euro bullet

BY PIALUISA BIANCO

One of the most troubling features of today's global economic crisis is the lack of political leadership, anywhere. No one has the courage to tell their people the truth. And the truth is that four of the pillars of today's economy – Europe, the United States, China (not to mention the other emerging economies) and the Arab world – have each, in their own way, squandered much of the capital (political and otherwise) they have earned in recent decades. Now they have to dig themselves out of their respective holes with fewer resources, less time and more pain.

Underlying that truth is a more obvious one: something is very wrong with the world economy. And that something is compelling us to flirt with financial catastrophe. Economies everywhere are weakening. The recession in the eurozone's periphery is biting harder, and as it does the periphery will not suffer alone; the downgrading of a host of German and international banks in June was a portent of that. America's recovery seems to be in trouble. The biggest emerging markets are hitting a wall too. Brazil's GDP is growing more slowly than Japan's. India is a mess. China's slowdown is intensifying. If the global recovery falters any more, there will be widespread stagnation.

Then there is the Arab world after 50 years of autocratic rule: Arab leaders used their surplus of power and wealth to ignore the deficit of freedom, knowledge and women's empowerment. Now they have to build viable new institutions with a fractured political system and huge youth populations. According to OECD data, they must create 25 million new jobs over the next 10 years to maintain the unemployment rate at the current 33%. The continuing turmoil in the streets of Egypt today says it all.

But that pales compared to a possible collapse of the euro. The EU, the world's biggest economic area, with the largest banking system, could plunge into a tailspin of bank busts, defaults and depression – a financial calamity to dwarf the mayhem unleashed by the bankruptcy of Lehman Brothers in 2008. And this time it will be harder to counter.

Europe's bickering politicians must now deal definitively with the euro. If they come up with a credible solution, it won't ensure a smooth ride for the world economy. But not coming up with a solution guarantees an economic tragedy, because a major eurozone upheaval would inevitably cause a global crisis.

The euro-debate has become an infantile shouting match about a number of specious choices: fiscal austerity vs growth, spending cuts vs jobs, market reform vs social model. Europe's leaders need to step out of the playground, because the euro may be dead before all this can be done. Citizens, investors, and policymakers should put to rest the idea that there is some silver bullet striking at the "right" side of an either/or equation, which could quickly put Europe out of its misery. Rather, they must recognize the choices for what they are – smoke and mirrors – and bite that bullet, lead and all, in a comprehensive overhaul: austerity *and* structural reform leading to growth; spending cuts *and* labor market reform leading to jobs for the young, market reform *and* the willingness to make the welfare state more efficient.

Two short years ago, if anyone had suggested that we would be considering pan-European bank regulation, cross-border deposit guarantees, variations of eurobonds, and the very survival of the common currency, they would have been dismissed as nothing short of crazy. What was unthinkable has become inevitable. We can now say that the staid EU we knew for its first decades is a thing of the past. What will take its place is still uncertain. The unfolding European financial crisis has the potential to be devastating. While unlikely to be as dangerous as the events of the 1930s, it could have incalculable consequences for the international order. There are worrying signs of global fragmentation, including retrenchment in international banking, reductions in cross-border lending and in funding markets. After so many summits and less formal political chinwagging, a game plan and a timetable that shows us where Europe is going are needed immediately.

But can European leaders envisage a set of reforms that are politically feasible, economically workable, and would allow it to prosper? If so what might they be?

At this point, for the sake of clarity, governments should at least start by publicly agreeing on what they can agree on. Everyone can sign up to the idea that deficits and debts must be brought down to sustainable levels. All should be able to admit that restoring competitiveness in the peripheral economies will require wrenching structural reforms. It is also self-evident that without economic growth, debts and deficits will remain high and political consent will evaporate. You do not have to be a Keynesian or Krugmanite to recognize debt traps. What matters is the mix and sequencing of policy choices. Deficit reduction depends on growth, but growth is sustainable only in the context of preprogrammed fiscal discipline. Without these basic ingredients, all the rest, including the quest for a stronger union, is academic, wishful-thinking at best, political opportunism at worst.

So how to get the policy mix right? A number of policy reforms may improve economic conditions in the eurozone, but none offers a panacea. Eurobonds, increased investment in struggling economies through the European Investment Bank and other funds, stricter regulations of banks, a common deposit insurance system, a shift from budget cuts to structural reforms that enhance productivity and encourage private-sector job creation: all of these could improve the EU's economic situation and should be implemented. But none of these measures would quickly restore growth or bring employment back to the pre-crisis levels. That is because they do not address Europe's central problem: the massive debt accumulated during the last decade's credit boom. And when countries suffer a recession caused by a financial crisis and debt overhang, they take many years to recover.

The reasons why the euro is so close to catastrophe is now visible to all European countries: the undoubted excesses in the continent's social model along with the patent mistakes in Greece, Ireland, Portugal, Spain, Italy and the other debtor countries have been compounded over the past two years by negligence in Europe's creditor countries. The overwhelming austerity, the succession of half-baked rescue plans, the refusal until now to lay out a clear path for the fiscal and banking integration needed for the single currency to survive, these too are fraught with risk. No good choices exist. Rather, the political will for a grand compromise must be summoned.

The EU and its common currency will probably hold together, but the road to recovery will still be long. And as Europe begins to readjust, the world's weak economy will have to grapple with ineptitude elsewhere. But at least it will have stepped back from disaster.