The euro crisis: Europe’s Achilles heel | The Economist

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THE respite in the euro crisis lasted a few short months. Now, despite a €130 billion ($169 billion) second bail-out for Greece, a fiscal compact agreed on by the euro-zone leaders in December, and €1 trillion of cheap long-term loans from the European Central Bank, the night terrors are back. How dispiriting that Europe is still so ill-prepared for the ordeal to come. Time is short. In France voters have given their new president, François Hollande, a mandate to alter the “austere” course set by his ousted predecessor, Nicolas Sarkozy, and Angela Merkel, Germany’s chancellor, and to focus on growth. Mrs Merkel says she will not change the fiscal compact, but Mr Hollande needs something to show voters in legislative polls next month. More threatening is the second election looming in Greece, where parties are struggling to form a government. If a majority of Greeks again vote to reject the spending cuts and reforms that go with their country’s bail-out, then euro-zone governments—in particular, Germany’s—will face a drastic choice. Mrs Merkel will either accommodate Greece and swallow the moral hazard of rewarding defiance or, more likely, stand firm and cut the Greeks adrift (see article (http://www.economist.com/node/21554549 )).

The idea of a chaotic Greek departure from the euro at a time of Franco-German disunion should terrify everyone it touches (the damage it would do the world economy may well be the biggest risk to Barack Obama’s chances of re-election, for instance). With so much at stake, the rest of the euro zone urgently needs to lower the risk that contagion from a Greek exit would infect Portugal, Ireland and even Spain and Italy. The worry is that, just at the moment when hardheaded realpolitik is needed, politics has fallen prey to self-delusion, with leaders in all the main countries peddling seductive half-truths that promise Europe’s citizens an easier way out.

Stories that people tell...
The euro zone needs to do a lot of hard things. Our list would include at the very least: in the short term, slower fiscal adjustment, more investment, looser monetary policy to promote growth and a thicker financial firewall to protect the weaklings on the periphery from contagion (all of which the Germans dislike); in the medium term, structural reforms to Europe’s rigid markets and outsize welfare states (not popular in southern Europe), coupled with a plan to mutualise at least some of the outstanding debt and to set up a Europe-wide bank-resolution mechanism (a tricky idea for everyone). It is an ambitious agenda, but earlier this year, with the Italians, Spanish and Greeks all making some hard choices and ECB money flushing through, the politics seemed possible.

Now they have lurched into dreamland. France is the most obvious example. Mr Hollande is right that growth would transform Europe’s prospects, by making debt more manageable, restoring banks and curtailing unemployment. But that truth is undone by two falsehoods. Although he pays lip-service to fiscal consolidation, he has, above all, promised to spend and tax his way out of the crisis, leaving French voters with the fantasy that the rich can pay and that their own hardship will be limited. And he has told them that liberalism, privatisation and deregulation are to blame for Europe’s crisis: France is now committed to the idea of sheltering behind the very barriers to enterprise that have made its economy uncompetitive.

In the short term Mr Hollande should be able to find a compromise with Mrs Merkel: a growth pact could be added to the fiscal one. There is also indeed a good case for Germany doing more to boost demand. But Mr Hollande will have to countenance reform all the same, because he needs a credible medium-term plan to pay for welfare spending without resorting to borrowing. Moreover, as its neighbours embrace reform, France will have to join them or see unemployment grow and wages stagnate. How wonderful it would be if a cut in interest rates, 60,000 extra teachers and some new roads could spare the French from all this. But that growth fairy does not exist.

…and the stories they believe

Across Europe the pattern repeats itself. In Italy the half-truth is that the country can escape its dysfunctional politics by entrusting hard choices to a technocrat. Its prime minister, Mario Monti, is indeed a gifted man, but the strong protest vote in this week’s local elections suggests that unpopular policies which touch so many Italian lives are ultimately best determined by elected politicians. The German half-truth is that the euro zone’s problems can be solved merely by the indebted countries slashing their way to prosperity. In fact, Germans need to live with higher inflation, consume a bit more and prop up the weaker members of the currency union. Indeed, the euro will survive only if every country confronts the choice it shies away from. Like some dreadful joke, the euro needs French reform, German extravagance and Italian political maturity.

It is worst of all in Greece. The half-truth in Athens is that bigoted northern Europeans give Greeks no credit for the hardship they have borne. Greece really has suffered: between 2007 and 2012 its economy is expected to have shrunk by almost a fifth. The economy is being strangled by a severe credit and liquidity crunch, with more budget cuts and tax rises to come. Even if all goes well, Greece’s debt will be 161% of GDP next year. Whatever the make-up of its next government, the idea that Greece can repay this is the biggest fantasy of all.

Does that mean Greece is still better off in the euro? Probably, though the judgment gets ever finer. An exit, and the ensuing default, would lighten its debt, re-establish competitiveness and challenge its politicians to grasp their own destiny. Yet leaving the euro would also create chaos
and destroy savings and, as often in the past, its advantages might rapidly inflate away. The rest
of the euro zone is also better off with Greece “in”, if only because of the risk of contagion (and
the inadequate preparations for that). But again, not at any price.

If Greece rejects the second bail-out or falls drastically behind in its programme, its exit could
become inevitable. Mrs Merkel and Mr Hollande may have as little as a month to prepare for that.
They have a lot of work to do.