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Charlemagne

April showers on the euro

The euro crisis is back, and resolving it is not getting any easier

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LIKE Brussels, with its fickle weather, the euro crisis enjoyed a hint of summer but has now returned to wintry gloom. The sun shone after the European Central Bank took action to avert a credit crunch. Now the storm clouds are blowing in from Spain. Yields on Spanish bonds are rising dangerously, and Italian ones are close behind. Like Spain, Italy will miss its deficit target this year and next. Portugal may also need fresh support.

For Eurocrats, these are but passing squalls. Summer will come, they say, so long as everybody sticks to the plans for deficit reduction. Spain is on track, insists Jean-Claude Juncker, head of the euro group of finance ministers. The IMF this week revised up its growth projections: the euro zone's recession this year will be milder than it previously thought. So why the renewed panic?

One reason is that markets are shifting their concern from deficits to growth. They fear that budget cuts are pushing countries ever deeper into recession. Investors may be as fickle as the weather, but the IMF, too, is warning against over-zealous austerity. Another reason is political mismanagement. The Spanish government delayed its budget for 2012 because of an election in Andalusia, created suspicions about the accuracy of its statistics, was cack-handed in its negotiation with the EU over a revised deficit target and messed up a bond sale just before Easter.

The EU is more worried about its own credibility. Its new system of economic governance to impose fiscal discipline is coming into force. It cannot just look the other way when Spain wildly misses its target (with a deficit of 8.5% of GDP in 2011 instead of 6%). A compromise has given Spain a looser target this year, while keeping the objective of cutting the deficit to 3% of GDP next year. But that looks unachievable. The EU thinks sticking to targets is essential to restoring market confidence. Yet stubbornly chasing an implausible objective may also sap credibility.

Beyond such economic worries, there is renewed political uncertainty. The election in Greece on May 6th is unpredictable, and a strong showing by anti-austerity parties could cast doubt on Greeks' commitment to reforms. Even more important is the French presidential election, in which the rhetoric of both leading candidates may be a harbinger of fresh EU turmoil. Most Eurocrats had thought that the re-election of Nicolas Sarkozy, difficult as he may be, was preferable to the election of his challenger, François Hollande. The Socialist front-runner

wants to renegotiate the euro's fiscal compact. Few think the compact will solve the crisis, but at least it preserves German support and provides cover for the ECB to keep providing liquidity. The ECB has issued €1 trillion ($1.3 trillion) of cheap loans to banks which, in turn, have bought high-yielding bonds from troubled countries. This Sarkozy trade, as it is sometimes known in the markets, was an indirect (if inefficient) means for the ECB to support sovereigns.

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Yet as the election has neared, Mr Sarkozy has switched from saviour to scourge of the EU and the euro, talking of reimposing border controls and trade protection and, most recently and most distressingly, leading an assault on the ECB's hallowed independence. He has demanded that it focus on promoting growth as well as fighting inflation, and that it devalue the currency to boost exports. This is a breach of last year's pact of silence, in which European leaders stopped exerting public pressure on the ECB. Mr Sarkozy may have delighted in leading the EU with the German chancellor, Angela Merkel. But he now talks wistfully of Charles de Gaulle's 1965 "empty chair" boycott of European institutions. This may just be electioneering, but if the ECB is called upon to help once again, it may be less obliging.

In some ways the crisis may have become more serious now, as today's policy tools lose some of their edge. Spain is a far larger problem than Greece, and it could drag down Italy and perhaps even France. The euro's financial firewall has been strengthened, but it remains inadequate. The effect of the Sarkozy trade is fading fast. And it has loaded banks' balance sheets with even more dodgy sovereign bonds, reinforcing the potential for a cycle of weak banks and weak governments to drag each other down. More austerity will damage both banks and sovereigns, in turn pulling down the economy.

In search of summer

What the euro zone needs is the means to break one or all of these feedback loops. The IMF says the euro zone should use its rescue funds to recapitalise weak banks in countries that cannot do so (ie, Spain), or bring in joint Eurobonds to reduce borrowing costs and create a safe asset. The ECB should loosen monetary policy to help growth (and keep using its liquidity and bond-buying tools). Strong countries should do more to boost demand. This is all good advice, but it is not going to be heeded soon.

The logic of the crisis requires the euro zone to become a more coherent economic unit. But national politics is often pushing countries apart. For now Germany will not hear of a European banking union, let alone a full-fledged system of fiscal transfers. And even if it were prepared to think of these things, France, whether run by Mr Sarkozy or by Mr Hollande, will resist the closer political union that Germany might demand as its price.

Perhaps leaders will change their minds when confronted with the dreadful prospect of a break-up; perhaps the ECB will bend the rules again rather than face extinction. Or perhaps the time will come when the world imposes adjustment on the whole euro zone, and not just on its most troubled members. By even the most optimistic view, matters will get worse before they slowly and painfully get better. A recent presentation by Goldman Sachs speaks of Europe's long march to recovery. But unless the politicians deal with the euro's underlying flaws, it could become a long and painful death march.

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