

The decline and fall of the euro?

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Great empires rarely succumb to outside attacks. But they often crumble under the weight of internal dissent. This vulnerability seems to apply to the eurozone as well.

Key macroeconomic indicators do not suggest any problem for the eurozone as a whole. On the contrary, it has a balanced current account, which means that it has enough resources to solve its own public-finance problems. In this respect, the eurozone compares favourably with other large currency areas, such as the United States or, closer to home, the United Kingdom, which run external deficits and thus depend on continuing inflows of capital.

In terms of fiscal policy, too, the eurozone average is comparatively strong. It has a much lower fiscal deficit than the US (4% of GDP for the eurozone, compared to almost 10% for the US).

Debasement of the currency is another sign of weakness that often precedes decline and breakup. But, again, this is not the case for the eurozone, where the inflation rate remains low – and below that of the US and the UK. Moreover, there is no significant danger of an increase, as wage demands remain depressed and the European Central Bank will face little pressure to finance deficits, which are low and projected to disappear over the next few years. Refinancing government debt is not inflationary, as it creates no new purchasing power. The ECB is merely a “central counterparty” between risk-averse German savers and the Italian government.

Much has been written about Europe’s sluggish growth, but the record is actually not so bad. Over the last decade, *per capita* growth in the US and the eurozone has been almost exactly the same.

Given this relative strength in the eurozone’s fundamentals, it is far too early to write off the euro. But the crisis has been going from bad to worse, as Europe’s policymakers seem boundlessly capable of making a mess out of the situation.

The problem is the internal distribution of savings and financial investments: although the eurozone has enough savings to finance all of the deficits, some countries struggle, because savings no longer flow across borders. There is an excess of savings north of

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the Alps, but northern European savers do not want to finance southern countries like Italy, Spain, and Greece.

That is why the risk premia on Italian and other southern European debt remain at 450-500 basis points, and why, at the same time, the German government can issue short-term securities at essentially zero rates. The reluctance of Northern European savers to invest in the euro periphery is the root of the problem.

So, how will northern Europe's 'investors' strike' end?

The German position seems to be that financial markets will finance Italy at acceptable rates if and when its policies are credible. If Italy's borrowing costs remain stubbornly high, the only solution is to try harder.

The Italian position could be characterised as follows: "We are trying as hard as humanly possible to eliminate our deficit, but we have a debt-rollover problem."

The German government could, of course, take care of the problem if it were willing to guarantee all Italian, Spanish, and other debt. But it is understandably reluctant to take such an enormous risk - even though it is, of course, taking a big risk by not guaranteeing southern European governments' debt.

The ECB could solve the problem by acting as buyer of last resort for all of the debt shunned by financial markets. But it, too, is understandably reluctant to assume the risk - and it is this standoff that has unnerved markets and endangered the euro's viability.

Managing a debt overhang has always been one of the toughest challenges for policymakers. In antiquity, the conflicts between creditors and debtors often turned violent, as the alternative to debt relief was slavery. In today's Europe, the conflict between creditors and debtors takes a more civilised form, seen only in European Council resolutions and internal ECB discussions.

But it remains an unresolved conflict. If the euro fails as a result, it will not be because no solution was possible, but because policymakers would not do what was necessary.

The euro's long-run survival requires the correct mix of adjustment by debtors, debt forgiveness where this is not enough, and bridge financing to convince nervous financial markets that the debtors will have the time needed for adjustment to work. The resources are there. Europe needs the political will to mobilise them.