

The Economist

The euro zone

Is this really the end?

Unless Germany and the ECB move quickly, the single currency's collapse is looming

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EVEN as the euro zone hurtles towards a crash, most people are assuming that, in the end, European leaders will do whatever it takes to save the single currency. That is because the consequences of the euro's destruction are so catastrophic that no sensible policymaker could stand by and let it happen.

A euro break-up would cause a global bust worse even than the one in 2008-09. The world's most financially integrated region would be ripped apart by defaults, bank failures and the imposition of capital controls (see [article](#)). The euro zone could shatter into different pieces, or a large block in the north and a fragmented south. Amid the recriminations and broken treaties after the failure of the European Union's biggest economic project, wild currency swings between those in the core and those in the periphery would almost certainly bring the single market to a shuddering halt. The survival of the EU itself would be in doubt.

Yet the threat of a disaster does not always stop it from happening. The chances of the euro zone being smashed apart have risen alarmingly, thanks to financial panic, a rapidly weakening economic outlook and pigheaded brinkmanship. The odds of a safe landing are dwindling fast.

Markets, manias and panics

Investors' growing fears of a euro break-up have fed a run from the assets of weaker economies, a stampede that even strong actions by their governments cannot seem to stop. The latest example is Spain. Despite a sweeping election victory on November 20th for the People's Party, committed to reform and austerity, the country's borrowing costs have surged again. The government has

just had to pay a 5.1% yield on three-month paper, more than twice as much as a month ago. Yields on ten-year bonds are above 6.5%. Italy's new technocratic government under Mario Monti has not seen any relief either: ten-year yields remain well above 6%. Belgian and French borrowing costs are rising. And this week, an auction of German government Bunds flopped.

The panic engulfing Europe's banks is no less alarming. Their access to wholesale funding markets has dried up, and the interbank market is increasingly stressed, as banks refuse to lend to each other. Firms are pulling deposits from peripheral countries' banks. This backdoor run is forcing banks to sell assets and squeeze lending; the credit crunch could be deeper than the one Europe suffered after Lehman Brothers collapsed.

Add the ever greater fiscal austerity being imposed across Europe and a collapse in business and consumer confidence, and there is little doubt that the euro zone will see a deep recession in 2012—with a fall in output of perhaps as much as 2%. That will lead to a vicious feedback loop in which recession widens budget deficits, swells government debts and feeds popular opposition to austerity and reform. Fear of the consequences will then drive investors even faster towards the exits.

Past financial crises show that this downward spiral can be arrested only by bold policies to regain market confidence. But Europe's policymakers seem unable or unwilling to be bold enough. The much-ballyhooed leveraging of the euro-zone rescue fund agreed on in October is going nowhere. Euro-zone leaders have become adept at talking up grand long-term plans to safeguard their currency—more intrusive fiscal supervision, new treaties to advance political integration. But they offer almost no ideas for containing today's conflagration.

Germany's cautious chancellor, Angela Merkel, can be ruthlessly efficient in politics: witness the way she helped to pull the rug from under Silvio Berlusconi. A credit crunch is harder to manipulate. Along with leaders of other creditor countries, she refuses to acknowledge the extent of the markets' panic (see [article](#)). The European Central Bank (ECB) rejects the idea of acting as a lender of last resort to embattled, but solvent, governments. The fear of creating moral hazard, under which the offer of help eases the pressure on debtor countries to embrace reform, is seemingly enough to stop all rescue plans in their tracks. Yet that only reinforces investors' nervousness about all euro-zone bonds, even Germany's, and makes an eventual collapse of the currency more likely.

This cannot go on for much longer. Without a dramatic change of heart by the ECB and by European leaders, the single currency could break up within weeks. Any number of events, from the failure of a big bank to the collapse of a government to more dud bond auctions, could cause its demise. In the last week of January, Italy must refinance more than €30 billion (\$40 billion) of bonds. If the markets balk, and the ECB refuses to blink, the world's third-biggest sovereign borrower could be pushed into default.

The perils of brinkmanship

Can anything be done to avert disaster? The answer is still yes, but the scale of action needed is growing even as the time to act is running out. The only institution that can provide immediate relief is the ECB. As the lender of last resort, it must do more to save the banks by offering unlimited liquidity for longer duration against a broader range of collateral. Even if the ECB rejects this logic for governments—wrongly, in our view—large-scale bond-buying is surely now justified by the ECB's own narrow interpretation of prudent central banking. That is because much looser monetary policy is necessary to stave off recession and deflation in the euro zone. If the ECB is to fulfil its mandate of price stability, it

must prevent prices falling. That means cutting short-term rates and embarking on “quantitative easing” (buying government bonds) on a large scale. And since conditions are tightest in the peripheral economies, the ECB will have to buy their bonds disproportionately.

Vast monetary loosening should cushion the recession and buy time. Yet reviving confidence and luring investors back into sovereign bonds now needs more than ECB support, restructuring Greece’s debt and reforming Italy and Spain—ambitious though all this is. It also means creating a debt instrument that investors can believe in. And that requires a political bargain: financial support that peripheral countries need in exchange for rule changes that Germany and others demand.

This instrument must involve some joint liability for government debts. Unlimited Eurobonds have been ruled out by Mrs Merkel; they would probably fall foul of Germany’s constitutional court. But compromises exist, as suggested this week by the European Commission (see [Charlemagne](#)). One promising idea, from Germany’s Council of Economic Experts, is to mutualise all euro-zone debt above 60% of each country’s GDP, and to set aside a tranche of tax revenue to pay it off over the next 25 years. Yet Germany, still fretful about turning a currency union into a transfer union in which it forever supports the weaker members, has dismissed the idea.

This attitude has to change, or the euro will break up. Fears of moral hazard mean less now that all peripheral-country governments are committed to austerity and reform. Debt mutualisation can be devised to stop short of a permanent transfer union. Mrs Merkel and the ECB cannot continue to threaten feckless economies with exclusion from the euro in one breath and reassure markets by promising the euro’s salvation with the next. Unless she chooses soon, Germany’s chancellor will find that the choice has been made for her.