The euro zone

The world’s biggest economic problem

Deflation in the euro zone is all too close and extremely dangerous

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THE world economy is not in good shape. The news from America and Britain has been reasonably positive, but Japan’s economy is struggling and China’s growth is now slower than at any time since 2009. Unpredictable dangers abound, particularly from the Ebola epidemic, which has killed thousands in West Africa and jangled nerves far beyond. But the biggest economic threat, by far, comes from continental Europe.

Now that German growth has stumbled, the euro area is on the verge of tipping into its third recession in six years. Its leaders have squandered two years of respite, granted by the pledge of Mario Draghi, the European Central Bank’s president, to do “whatever it takes” to save the single currency. The French and the Italians have dodged structural reforms, while the Germans have insisted on too much austerity. Prices are falling in eight European countries. The zone’s overall inflation rate has slipped to 0.3% and may well go into outright decline next year. A region that makes up almost a fifth of world output is marching towards stagnation and deflation.

Optimists, both inside and outside Europe, often cite the example of Japan. It fell into deflation in the late-1990s, with unpleasant but not apocalyptic consequences for both itself and the world economy. But the euro zone poses far greater risks. Unlike Japan, the euro zone is not an isolated case: from China to America inflation is worryingly low, and slipping. And, unlike Japan, which has a homogenous, stoic society, the euro area cannot hang together through years of economic sclerosis and falling prices. As debt burdens soar from Italy to Greece, investors will take fright, populist politicians will gain ground, and—sooner rather than later—the euro will collapse.

This parrot has ceased to be

Although many Europeans, especially the Germans, have been brought up to fear inflation, deflation can be still more savage (see article). If people and firms expect prices to fall, they stop spending, and as demand sinks, loan defaults rise. That was what happened in the Great Depression, with especially dire consequences in Germany in the early 1930s.

So it is worrying that, of the 46 countries whose central banks target inflation, 30 are below their target. Some price falls are welcome. Tumbling oil prices, in particular, have given consumers' incomes a boost (see article). But slowing prices and stagnant wages owe more to weak demand in the economy and roughly 45m workers are jobless in the rich OECD countries. Investors are starting to expect lower inflation even in economies, such as America's, that are growing at reasonable rates. Worse, short-term interest rates are close to zero in many economies, so central banks cannot cut them to boost spending. The only ammunition comes from quantitative easing and other forms of printing money.

The global lowflation threat is a good reason for most central banks to keep monetary policy loose. It is also, in the longer term, a prompt to look at revising inflation targets a shade upwards. But the immediate problem is the euro area.

Continental Europe's economy has plenty of big underlying weaknesses, from poor demography to heavy debt and sclerotic labour markets. But it has also made enormous policy mistakes. France, Italy and Germany have all eschewed growth-enhancing structural reforms. The euro zone is particularly vulnerable to deflation because of Germany's insistence on too much fiscal austerity and the ECB's timidity. Even now, with economies contracting, Germany is still obsessed with deficit reduction for all governments, while its opposition to monetary easing has meant that the ECB, to the obvious despair of Mr Draghi, has done far less than other big central banks in terms of quantitative easing (notwithstanding this week's move to start buying "covered bonds").

If there was ever logic to this incrementalism, it has run out. As budgets shrink and the ECB struggles to convince people that it can stop prices slipping, a descent into deflation seems all too probable. Signs of stress are beginning to appear in both the markets and politics. Bond yields in Greece have risen sharply, as support for the left-wing Syriza party has surged (see article). France and Germany are trading rhetorical blows over a new budget proposal coming out of Paris.

Joining the bleedin' choir invisible

If Europe is to stop its economy getting worse, it will have to stop its self-destructive behaviour. The ECB needs to start buying sovereign bonds. Germany's chancellor, Angela Merkel, should allow France and Italy to slow the pace of their fiscal cuts; in return, those countries should accelerate structural reforms. Germany, which can borrow money at negative real interest rates, could spend more building infrastructure at home.

That would help, but not be enough. It is a bit like the early years of the euro debacle, before Mr Draghi's whatever-it-takes pledge, when half-solutions only fed the crisis. Something radical is needed. The hitch is that European law bans many textbook solutions, such as ECB purchases of newly issued government bonds. The best legal option is to couple a dramatic increase in infrastructure spending with bond-buying by the ECB. Thus the European Investment Bank could launch a big (say €300 billion, or $383 billion) expansion in investments such as faster cross-border rail links or more integrated electricity grids—and raise the money by issuing bonds, which the ECB could buy in the secondary market. Another possibility would be to redefine the EU's deficit rules to exclude investment spending, which would allow governments to run bigger deficits, again with the ECB providing a backstop.

Behind all this sits a problem of political will (see article about Charlemagne). Mrs Merkel and the Germans seem prepared to take action only when the single currency is on the verge of catastrophe. Throughout Europe people are hurting—in Italy and Spain youth unemployment is above 40%. Voters vented their fury with the established order in the EU's parliamentary elections earlier this summer, and got very little change. Another descent into the abyss will test their patience. And once deflation has an economy in its jaws, it is very hard to shake off. Europe's leaders are running out of time.

Charlemagne

Gummed up

Europe’s leaders need to rediscover the resolve they showed during the euro crisis

IT WAS just like old times. On October 16th, almost five years to the day after Greece’s government triggered the euro crisis by confessing that its budget deficit was twice as big as had previously been reported, yields on Greek ten-year debt rose to 9%, and share prices tumbled. Long-suppressed memories of bail-outs, late-night summits and market meltdowns briefly resurfaced. Perhaps the crisis wasn’t over after all?

The panic soon subsided. Investors’ concerns were limited to political uncertainty in Greece, and a plan by the country’s embattled prime minister, Antonis Samaras, to exit its IMF bail-out programme early. Greece remains the runt of the euro-zone litter, labouring under a debt pile equivalent to 175% of GDP and a sky-high unemployment rate. But there are slivers of light: after six grinding years of recession, it may grow modestly this year. Elsewhere, too, the champions of austerity have found cause for cheer: unemployment is down and output up (a bit) in Spain and Portugal; Ireland, which had to be bailed out in 2010, seems to be experiencing a mini-boom. Even France and Italy appear finally to have accepted the need to reform.

The overall picture, though, remains bleak: growth prospects are dismal and unemployment within the euro area stands at 11.5%. What to do? Rather like the quest for peace in the Middle East, everyone knows what to aim for but no one knows how to get there. France and Italy need to cut red tape and ease their labour laws, in exchange for more time to get their budgets in shape. The Germans need to invest at home, and not to stand in the way of the European Central Bank moving towards quantitative easing (printing money to buy sovereign debt).

But such moves need political and economic co-ordination, and trust is in short supply. The Germans have lost patience with the French, who are wary of being lumped in with the Italians, who think the German obsession with fiscal rigour in a time of recession absurd. Small countries resent big-country stitch-ups (another, on the French budget, looks imminent). Mario Draghi's accommodating stance at the ECB is testing the patience of German politicians and constitutional judges, and inaction at national level will anyway dull the effects of monetary activism.

The machine is not entirely gummed up. The international chorus urging Germany to loosen up a bit may be getting through; this week the German and French finance ministers said they would present a growth and investment plan by December, though they gave no details. The Poles think they are making headway with a proposed €700 billion ($894 billion) pan-European investment fund, and Jean-Claude Juncker, the incoming president of the European Commission, will soon present his own ideas. But Europe has never lacked for grand investment plans; it is the will to execute them that has been in short supply.

The smack of firm bond yields

One way to understand the impasse is to look at the lessons that governments drew from the wrenching years of the euro crisis. Rather than rely on flaky politicians and spendthrift central bankers, Germans and others found the iron rod of the market the most effective means to bring discipline to the wayward. It was spiralling bond yields, not bunga-bunga scandals or legal troubles, that rid them of the troublesome Silvio Berlusconi in 2011. Greece, Ireland and Portugal reformed their economies, and trimmed their budgets, only under the whip of international supervision after being forced into bail-outs. Even in these "programme" countries some officials acknowledge, *sotto voce*, that they would have struggled to make such changes in calmer times.

For a supposedly slow-moving place, the European Union has shown that in the teeth of crisis it can transform its machinery at great haste. Vast bail-out funds have been engineered, rule books torn up and rewritten, sovereign debt restructured. Many predicted the euro could not survive. In 2012 Angela Merkel, Germany's chancellor, and her advisers indeed considered cutting Greece loose, but ultimately determined that the currency must remain intact. Here there has been no lack of political will, of a sort.

Yet it has evaporated as the crisis has subsided and economies have stagnated. Europe today lacks leadership. Mrs Merkel holds power but does not wield it. Her fellow heads of government are diminished figures, struggling to navigate their own fractured domestic political terrain. The heyday of the installed functionaries in Brussels appears to have been about 20 years ago. Mr Draghi has shown courage but represents no one. And populists are rising to plug the political vacuum, in both creditor and debtor countries. Syriza, a hard-left party that wishes to stiff creditors, may win power in Greece next year. If that happens, the market will probably panic again.

As with everything in Europe these days, change must come first from Germany. Its (slight) softening on investment is welcome. But more is needed. Officials are wary of an Italian proposal to exclude investment spending from the figures used to calculate budget deficits. But such a change would allow governments to exploit low borrowing costs to earn later returns without falling foul of Brussels's rules. Another idea, proposed by the Lisbon Council, a think-tank, is for the new European Commission to identify reforms needed across euro-zone members, rather than pick on the usual suspects. As a start, it proposes that 11 countries jointly tackle their job-killing labour taxes.

Europe did well to hold together through the crisis years, but its failures are apparent: a jobless army 25m strong; millions more underemployed. Such numbers do not seem to galvanise politicians the same way bond yields at 7% do. "We are last-chance Europe," Mr Juncker told MEPs this week before they approved his new commission. But not everyone sees it that way.