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Could Europe and Asia take up the slack caused by a severe slowdown in US economic growth? The French and German economies performed so well during the second quarter that some now believe that the eurozone has finally overcome its growth crisis. Moreover, it may even be able to decouple from the US during a US recession, if it took one or all of the three following steps: 1st, switch European workers from exporting goods to producing domestic services, while importing more goods from the US; 2nd, cut interest rates aggressively; third, allow governments to run larger fiscal deficits. You might want to add that the euro区 should visit your town and bide plenty of cash under the pillow. The truth is that above all fear the euro zone could decouple from the US in the present. Moreover, in contrast, your average European may find a US recession more painful than your average American.

For a start, countries such as Germany and Italy are structurally locked on exports and suffer from an overdeveloped services sector. This makes it difficult for them to switch from exporting tradable goods to the production of non-tradables. The present European recovery is based on export-led growth that resulted in more investment and consumer spending after some delay. The recovery appears relatively robust, but suggests the euro zone’s exchange rate overshot against the dollar as part of a rebalancing of the US current account deficit. The euro zone’s export performance would suffer and the whole mechanism that led to the present recovery would go into reverse. In due course, employment, investment and consumption would all decline.

Second, monetary policy would not come to the rescue. While US interest rates may soon be heading downwards, European rates are still close to their zero lower bound. The Bund has already fallen below the 5 per cent level, and it is unlikely to hit its target range. The European Central Bank said in its latest monthly bulletin that the rise in oil prices had had knock-on effects on other prices. As is the case in the US, Europe is facing mild inflationary pressures as a result of the prolonged increase in oil prices. As long as these persist, central banks will be cautious even if the dollar plummed against the euro, which is becoming more likely as the gap between US and European short-term interest rates closes, the ECB would remain cautious. If the movement was temporary, it would be irrelevant to monetary policy. But even if the ECB believed it was permanent, it would take time to make the necessary adjustments, given its record. It would be likely to take further time for the decision to have an impact on the real economy because of the long transmission mechanism of monetary policy in the eurozone. What about fiscal policy? Here, the news is a little better. It is a common misunderstanding that the stability and growth pact acts as an artificial constraint. If the eurozone contracted, governments would be able to run a public sector deficit of more than 3 per cent of gross domestic product. The real constraint is the level of debt in some eurozone countries. Italy, for example, with a debt-to-GDP ratio of about 126 per cent, would face difficulties running an expansionary fiscal policy for more than short periods. Another problem is time lag in many countries, the political sysytems take so long to start and implement fiscal policy measures that their economic effects are only felt after the recession is over. Of the two mechanisms fiscal policy would be the most potent, but only in the sense that it provides some insurance against a depression in the form of automatic stabilisers. But there is no mechanism in place that would allow the eurozone to become a locomotive for the world economy, a mantle Germany unhappily adopted in the late 1990s. The most we could expect would be for the eurozone to succeed in minimising the negative impact of a US slowdown. Remember the last US recession? The US economy recovered from the 2001 recession within a few months, while the eurozone took another five years to return to pre-recession levels of economic growth. Economic insufficiency means shocks in the eurozone tend to persist for much longer than elsewhere. Eurozone countries have undertaken plenty of economic reforms, but of the wrong kind. They have focused on improving cost competitiveness rather than on measures to enhance flexibility, such as those to improve the working of financial markets, or to liberalise labour markets and the services industries.

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