The Path to Economic Decline 11th December 2009

A recent paper by the Levy Economics Institute "Can Euroland Survive?" is just the latest academic work taking a grim view on the euro's and the EU's prospects, based on alleged flaws in the underlying economic construction – which, according to the authors, will eventually lead to the demise of the common currency and maybe of the European Union itself. The central thesis of this paper – widely commented in the financial press – is that the inability of participating countries to properly stimulate the economy via deficit spending makes a downward economic spiral in the euro area more likely. Even Europe's economic recovery would be contingent on the continued support of the US federal Reserve acting as the lender of last resort of US dollars to the ECB.

I am convinced, on the contrary, that the more the US and the UK, with their unsound economic policies, are in trouble and the US dollar's role as reserve currency is questioned - the more we are going to read on the impending collapse of the euro.

The very idea that a recession caused by the implosion of a debt-induced bubble can be cured by saddling the economy with even more debt (deficit spending) is a mind boggling concept. As if one could borrow oneself out of debt! And the idea of the Federal Reserve coming to the rescue of the euro area shows utter complacency about the role of the US dollar and the power of the Fed on the world scene. To be truthful, however, one should never underestimate the power of a central bank determined to undermine its own currency.

The recently imploded US housing bubble has been termed "unprecedented". As a matter of fact, never before in the history of the US – or indeed any other country we can think of – people with no savings and little or no income were handed out houses virtually for free (remember sub-prime mortgages, liar loans, teaser-rate loans?) on the expectation that in no time the debt so assumed would be rescheduled on more favorable terms, aided by the ever increasing value of the collateral (i.e. homes).

The countries most affected by the implosion of their housing bubbles, notably the US and the UK, have not seized the chance to rebalance their economies on a more sustainable path. The adjustment cost, in terms of lost output and higher unemployment in the short term, from a debt-inflated unbalanced economy to a post-bubble sustainable one proved too unpalatable for most politicians. More ominously, for most central bankers too. Therefore, as soon as households started raising their saving rate in an attempt to repair their balance sheet, governments and central banks promptly intervened with more incentives to spend (cash for clunkers, cash for new homes), to borrow (zero interest rates) and expanding deficit spending. The saving ratio had to be hammered back to zero, lest the economy should contract for lack of spending.

The US and the UK are refusing to bite the bullet and are instead engaging in a dangerous experiment of simultaneous fiscal and monetary largesse on a scale never tried before (Weimar excepted). In a few years, their public debt/GDP ratio may well look very much like Italy's (120%), only without an adequate pool of domestic savings to sustain it. In the US case, unless its excessive reliance on foreign capital is addressed soon, the combination of high public debt, high private debt and a chronic current account imbalance may provide the ingredients for a debt-interest spiral. Not to mention the dangers associated with the loss of economic sovereignty: foreigners hold a growing proportion of US public debt and their indefinite continued support should not be taken for granted.

Despite all discussions about the symptoms of the recent financial crisis, not enough emphasis has been given to its underlying causes: excessive consumption in the US and excessive accumulation of US dollar claims by the emerging economies of Asia, notably China. While the US, lacking savings and deeper and deeper into debt, takes the path to economic decline, China produces and exports, saves and invests, gaining strength and becoming in the process the greatest creditor nation on the planet (I need not mention who the greatest debtor is). Of course all of this does not come cheap: by doing so China is artificially limiting its own citizens' real salaries, their lifestyle opportunities and not doing any favor to its own environment either. But its policies are not myopic, quite the opposite - assuming that China will somehow manage to find its own exit strategy from accumulating dollar claims that may prove in the end to be a less than sound investment.

Increasingly, there is talk of a new G-2 arrangement that would make all other G's (G-7, G-8, G-20) largely irrelevant. In a highly unbalanced world economy, the centre stage belongs to those who run large imbalances and execute "appropriate" economic policies to nurture them and to postpone those adjustments that would occur if market forces were left free to operate. The more reckless and ultimately unsustainable an economic policy the more it has to occupy our thoughts. Should however the G-2 countries lose their current entente or should either of those nations decide to unilaterally address their respective economic imbalances (e.g. China may stop preventing the appreciation of its currency, decrease its saving rate, accept a lower rate of growth and allow the living standards of its citizens to increase in line with the level of production capacity) this would have huge repercussions on the world economy and markets – currencies, interest rates and commodities alike.

Enter the euro area. Neither consuming too much nor too little, not being too big a net creditor or a net debtor to the rest of the world, it looks static and condemned to the role of the extra on the global scene. The euro area, taken as a whole, is an oasis of stability in a world of partial equilibriums. And stability is boring, is it not? The area is a 16-country economic space based on a common currency where a) the management of the currency is kept away from politicians and b) there are limits to deficit spending by the governments of participating countries. This is certainly not the gold standard but it provides a framework of discipline in a world of fiat currencies where those in charge normally face no such constraints.

It is indeed true, as noted in the above mentioned paper, that statistically the area is in deeper recession/shallower recovery than the US because of its greater overall fiscal restraint. But this is by choice and highlights a safer, sounder approach to fiscal policy. The euro area is dealing with the aftermath of the crisis without excessive accumulation of public debt (or private for that matter) and without seeking the depreciation of its currency. Being a very open economy, the area is bearing the brunt of the needed adjustments even if the trigger of the crisis came largely from outside. Contrary to popular clichés, the euro area is allowing, relatively speaking, the play of market forces, while the US and the UK are doing all they can to avoid the post-bubble adjustments in their respective economies.

This is not to mean that all is well inside the area, which has had to cope with its fair share of pain and semi-nationalisation of financial institutions. However things did not exactly turned out as critics expected. When this crisis started about two years ago and for a while after that, most anti-euro commentators were pointing the finger at Italy, supposedly the weak link because of its high public debt and its alleged lack of competitiveness. As it happened, Italy bit the bullet and did not intentionally increase public spending. The country's financial system, less leveraged than most, did comparatively well. In the end, the euro did not break apart as many predicted – at least not yet.

Now – it is a moving target exercise – critics point to Greece's and Ireland's fiscal trends. But in an economic and currency union of 330 million people these two countries combined represent just about 5% of the total. Negative developments in Spain – itself dealing with the bursting of its own housing bubble – could prove a test of a different order of magnitude but the consensus is that its debt is at limited risk. For the euro to collapse it would need more than a fiscal crisis in a small country like Greece or Ireland. And a debt crisis in a large country in the euro area won't happen anytime soon.

Could it be that while the US wastes away its economic dominance – by desperately trying to hang on to an unearned lifestyle and a doomed economic model – on the other side of the Atlantic a silent revolution is in the making?

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