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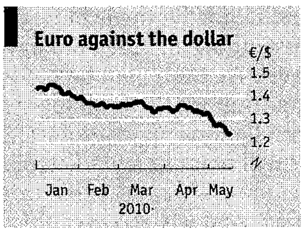
The euro-zone crisis

# Europe's three great delusions

**The continent's leaders have still not grasped how much they need to do to save the euro**




IT HAS been another turbulent week for the euro. Investors have pondered the €750 billion ($950 billion) rescue plan devised by euro-zone finance ministers—and remain nervous (see page 75). The euro has fallen sharply. Fears that the rescue plan will not be implemented may grow. But the real worry is that the time the plan should buy may be wasted as a result of three delusions which have overtaken European leaders.

The first is shoot-the-messenger syndrome. Too many European politicians lay all the blame on speculators, hedge funds, rating agencies and the rest for "unwarranted" attacks on the euro. Such thinking has informed Germany's decision to ban "naked" short-selling of government bonds. The German regulator itself admits that this practice played little part in the Greek mess. The ban will apply only in Germany, whereas most short-selling happens in London. If it has any impact at all, it will merely make it harder to sell government bonds.

The decision in Brussels to push through tough rules on hedge funds and private equity reflects an equally gormless view that such firms caused the financial crisis (see page 76). Nobody can deny that financial regulation needs to be improved. But to attribute the woes of euro-zone government-bond markets solely to evil speculators is dangerously misguided. In fact, investors everywhere (not least at home) have woken up, belatedly, to the extreme fiscal vulnerability of some euro-zone countries—and are now forcing budget cuts.

The second delusion might be termed excessive faith in shock-and-awe. Although the euro's rescue plan took weeks to devise, €750 billion is an undeniably big number. The European Commission's president, José Manuel Barroso, claimed it showed the euro zone would do "whatever it takes" to defend itself. Even less troubled euro-zone countries like Italy are pushing new fiscal austerity. Yet for Greece, faith in shock-and-awe seems misplaced. Even if it does everything it has promised (and it may well not), Greece will end up with public debt over 150% of GDP and at best meagre growth prospects. In truth, Greece's debt problem is one of insolvency, not illiquidity—and insolvency cannot be rectified by piling on more debt, however shocking and awesome the amount. Instead, euro-zone governments and regulators should start planning now for an orderly debt restructuring, including the imposition of losses ("haircuts") on banks that hold Greek debt.

### Burying Greek busts

The third and most disturbing delusion is that deeper structural reform is not necessary; everything will be fine if only Greece and other euro-zone laggards cut their budget deficits. Several notorious fiscal reprobates are promising Angela Merkel that they will whip themselves into line. This is both masochistic and cowardly. On the one hand, sharply reducing demand in economies that are recovering only weakly from recession may cause much unnecessary pain. But an obsession with fiscal discipline may also be an excuse for politicians to run away from tackling Europe's chronic imbalances and the loss of competitiveness in southern Europe.

Greece, Spain and Italy all made strenuous efforts to qualify for the euro. But once in, they relaxed and gave up the tiresome business of pushing through reforms to enhance competition, hold down labour costs and boost productivity. In fact their loss of monetary and exchange-rate flexibility makes these reforms more pressing—as the euro crisis has underlined. It also makes it imperative that Germany do more to boost domestic demand. How sad that most euro-zone governments still do not seem to get it; how pathetic that they cover their ignorance by blaming hedge-fund managers in London. ■