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# No easy answers for euro zone’s vicious cycle

**By David M. Smick,**

The euro zone crisis is back. Policymakers in those nations worry that they have entered a vicious cycle. Efforts at reform to demonstrate fiscal rectitude are leading to a weaker economy. The austerity medicine appears to be killing the patient.

For euro-zone policymakers in particular, the issue of austerity is awkward. That is because some of the periphery countries in the area of fiscal policy have, to put it bluntly, a history of cooking the books. They deserve the bitter medicine.

Yet not all nations are created equal. As economist Laura D’Andrea Tyson noted recently in the International Economy magazine, in 2008, Spain and Ireland were “models of fiscal rectitude” in their public debt exposure. Italy had the lowest deficit-to-GDP ratio among the euro-zone countries. Of course, the private debt of these countries reached explosive levels and became a driving force in their demise.

In recent years, euro-zone policymakers have operated under the theory that fiscal-policy restraint could actually be expansionary. Has this “expansionary contraction” thesis worked for Ireland, Spain or Greece? The austerity policies to reduce debt created a downward spiral of collapsing demand and employment. This shrank tax revenue such that budget deficits and debt actually increased. The Greek debt-to-GDP ratio was 127 percent in 2009; last year, it exceeded 160 percent.

Spain is the euro zone’s potential game-changer. Unlike Greece, its crisis began with its banks, rather than its sovereign debt. Its banks are now teetering on the edge. Economic growth has collapsed. Unemployment is at 24 percent, 50 percent among those ages 15 to 24. Spain’s still grossly overvalued real estate prices need to drop further. Yet Madrid promises greater budget discipline, even as the economy’s bond market collapses and interest rates rise. Financial markets have concluded that the timing is off — that adding further public deleveraging to the ongoing private deleveraging is a recipe for disaster.

This brings up important questions: Can austerity work without an accompanying policy for economic growth? Can there be bailouts for a country such as Greece, where a functioning government soon may no longer exist — or for a country with a political system in waiting that may no longer be committed to past agreements? President Sarkozy, call your office!

Ultimately, the euro zone's problem comes down to a lack of financial market confidence. Markets figure that rescuing the junior varsity squad — Greece, Portugal and Ireland — is tough but doable. When varsity members Italy and Spain come under suspicion, however, market confidence collapses. Even wealthy Germany couldn't afford the cost of that rescue operation.

You have to give euro-zone policymakers credit for their cleverness. Like magicians, they have directed the world's attention to trivial, short-term, tactical challenges — whether some Greek leader signs a paper agreeing to reforms, whether a Spanish bond auction goes well, and so forth. Meanwhile, a $7 trillion sovereign debt elephant stands unaddressed in the corner. No wonder the bond market vigilantes continue to wait at the door.

Some analysts argue that the problem in the euro zone is the euro itself. Currency risk, as analyst Bernard Connolly has observed, was converted into credit risk. Therefore, the banking and sovereign-debt crises are, as economist Martin Neil Baily has put it, "symptoms, not causes" of a euro zone unable to achieve convergence. In other words, countries operate under different levels of competitiveness with huge disparities in current account imbalances. That has left many nations in desperate need of dramatic currency depreciation. But under the euro, they have no way out.

Sweden, Finland, Mexico and Brazil are all recent cases in which austerity policies to bring down debt have worked because those countries achieved an export boom. Austerity without a dramatic increase in exports is a recipe for failure. Austerity alone shifts credit exposure even more onto working middle-class families who are already pressed.

Euro-zone governments have no choice but to continue pressuring their central bankers to buy massive amounts of public debt through banks. But there are complications. Bank stock prices are plummeting. The European Central Bank's leverage is eight times the amount that Lehman Brothers was using before that firm's demise in 2008.

Almost all of the world's major central banks are engaged in financial repression. Governments cajole their central banks (and the central banks' proxies, the big banks) to intervene in markets to achieve negative real interest rates. Their goal: to try to raise inflation to reduce the value of the debt.

Inflation, of course, is a highly regressive "tax" on already stagnating wages and salaries. No wonder European governments are dropping like flies. Politics have become the global economy's new systemic risk factor, its great unknown. The next crisis point could come with the Greek and French elections next month. Could new governments try to tear up previous bailout and budget agreements?