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Avoiding a global catastrophe

By Lawrence Summers, Published: June 18

Once again good news has had a half-life of less than 24 hours. Just as news of Spain's bank bailout rallied markets for only a few hours, a Greek election outcome that was as good as could have been hoped did not buoy markets for even a day. There could be no clearer evidence that the current strategy — vowing that the European system will hold, doing the minimum needed to address each crisis as it comes, and pledging at every juncture to build a system that is sound in the long run — has run its course.

Nor is the Group of 20 likely to change anything anytime soon. Europe's troubled economies will demand more emphasis on growth, lower interest rates on their official debts and more transfers. Germans will show sympathy with the goal of reform but will insist that financial integration coincide with political integration, noting that no one provides a credit card without maintaining control over its use. The rest of the world will express exasperation with Europe's failure to get its act together and demand that more be done. Officials blessed with more diplomatic ability than economic insight or courage will produce a communique expressing a measure of satisfaction with the steps underway and looking forward to continued dialogue. The only good thing is that expectations are so low, this is not likely to disappoint markets much.

The unfortunate truth is that European debtors and creditors are both right. The borrowers are correct that austerity and internal devaluation have never been a successful growth strategy, certainly not when major trading partners are stagnating. In the few cases where fiscal consolidation has preceded growth, they have involved stagnation relative to previous levels of income (as in Ireland and the Baltics) or buoyant demand associated with surging exports, increasing competitiveness and low borrowing costs (many euro members in the early years). The borrowers are also right to claim that even a previously healthy economy will quickly become sick if forced to operate for several years with interest rates far above growth rates, as is the case across Southern Europe. Experience clearly shows that structural reform, always difficult, is harder when an economy is contracting and there is no sector to absorb those displaced by reform.

Those chary of institutionalizing financial integration without major political integration also are right. In a sound system, those with deep pockets who must act as either borrowers or guarantors must have control over borrowing decisions. A system where I borrow and you repay is a prescription for unsustainable profligacy. This is why there is so much discussion of "euro-zone bonds" and Europe-wide deposit insurance being linked with much deeper political integration.

But two problems lie behind the soft references to greater integration. The first is the question of who really has control. If decisions are genuinely to be made by members of the euro zone, it is far from clear, especially after the French election, that there is any kind of majority or even plurality support for responsible policies. If the idea is that the euro zone's future will be modeled on the European Central Bank — a European facade behind which Teutonic policies are pursued — it is open to question whether this will or should be acceptable across the continent.

The second problem is the magnitude of the transfers that could be involved. During the U.S. savings-and-loan crisis, the Southwest received a transfer from the rest of the country equal to at least 20 percent of the region's GDP. Is there a real willingness to commit to potential transfers of this scale in Europe? Maybe all of this can be resolved, but surely it will not happen quickly.

And not all problems can be solved. It is not certain that the full repayment of all currently contracted sovereign debts, sustainable growth for all, and the euro zone retaining all of its members will prove feasible. The private sector is making clear that it recognizes this painful reality. Official-sector planning needs to recognize it as well. Outside Europe, even as leaders hope for the best they need to plan for the worst, ensuring adequate liquidity and demand in their economies even if Europe's situation deteriorates rapidly. The fortification of the International Monetary Fund is a start; policymakers also need to consider national strategies, trade finance and social safety nets.

A euro-zone collapse would be an economic disaster that might define our era. That prospect must focus the minds of all at the G-20 on immediate action. Those outside Europe must persuade Europeans that the rules change when the stakes rise. The European Central Bank's credibility will mean little if there is no longer a common currency.

Setting the right precedent seemed much more important 24 hours before Lehman Brothers' collapse than 24 hours afterward. Now is the time for radical cuts in the rates official creditors charge European sovereigns; for a willingness to subordinate official debts, not to privilege private creditors but to offer a prospect for systemic preservation; and for expansionary monetary policies in Europe that prevent deflation and encourage the growth that can create jobs and reduce debt. Only if the system is preserved can its future be debated.