

**Andrew Bell's Blog**  
9<sup>th</sup> November 2011

## Acropolis now?

It would be difficult to conceive a fictional plot with as many jinks and turns as the saga of politics and economic policy in Europe in recent months. **Introducing regime change into some of the garlic belt countries with debt problems may ultimately be good for economic management but it certainly complicates predicting the immediate path** for countries under pressure to adopt politically unpopular austerity measures.

One result of last week's "Papandemonium" relating to the Greek on/off referendum was to make it clear that **preventing contagion, not rescuing Greece, is the essential policy objective**. The extended time taken for Europe to reach virtual agreement (in more than one sense) has drawn an increasing list of countries into the "might need help" category. **If the funds available to cover the near-term financing needs of "at risk" countries are large enough, Greece's financial problems would simply be a problem for its people and their creditors**, rather than a wider systemic risk.

Meanwhile, **the weakening of European growth as a result of fiscal wrecktitude and an overvalued currency has increased projected deficits and therefore the amount of liquidity which might be needed**.

This would be a smaller and more manageable problem if the better managed "core" states were agreed on their policy, which clearly they are not. As a result, **the Eurozone has a central bank which is being constrained from acting as a lender of last resort (until it really is the last gasp) while its governments, led by Germany, cannot agree on a fund size which would dispel all doubts over its ability to cope with a buyers' strike in Italian and Spanish debt**. The larger the fund, the less likely it is to be needed. By contrast, the more that official support mechanisms are begrudged and too small, the longer the list of countries having problems funding themselves at realistic rates.

**Perhaps homeopathy is the answer. Such treatments involve diluting a compound to such a point that it is virtually undetectable**, or not even there. Believers nevertheless attest that it still has the expected benefits. **Perhaps Europe's leaders wish they could adopt such an approach - one Euro diluted homeopathically could become infinitely extended**. However, diluting the solution would only work if the patient believed in its efficacy, yet policy credibility in Europe is as rare as rocking horse manure.

Europe has to agree on a fund with a coherent structure and an agreed objective (deflation, not inflation is the central problem). If Europe can agree, the cash-rich emerging economies who snubbed it last week might assist, or back a parallel IMF fund.

**Market rates for Italy have moved to unsustainably high levels**. Although this creates headlines about financial ruin, it is not an immediate financing crisis, since existing debt will only pay this rate when it has to be rolled over. Nonetheless, **it adds to concerns over the financial strength of the banks, with knock on effects to their willingness to lend. The resulting market pressure acts as a powerful enforcement mechanism for**

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**economic reform**, without guaranteeing that the right decisions will be taken in time. Some good could come of this, if Europe adopts widespread structural reforms in order to regain markets' confidence. In the meantime, **there is a danger of creating a tipping point in the erosion of economic confidence.**

Aside from the immediate problem of restoring confidence and agreeing on a financial assistance structure that does not require rethinking every few weeks, **there are two other significant unaddressed problems. One is that structural change will not work in the absence of economic growth.** Fiscal retrenchment may make longer-term sense but has uncomfortable echoes of the 1930s, when governments either raised interest rates to hang onto the gold standard or tightened fiscal policy in response to recession-induced deficits. **There needs to be a growth plan, in the form of looser near-term fiscal policy, greater liquidity provision or a weaker Euro. Otherwise the longer-term structural reforms and fiscal discipline will be still-born.**

**The other casualty of the 2010-11 summits is the idea that the Euro is a partnership.** The inherent instabilities of allowing unready economies to join have led to fractures, with national interests dominating over the original common pursuit of the European ideal. **This will create stored-up resentments in donor and recipient countries – the electorates in both will feel the system has ridden roughshod over their sensitivities.**

**Although the risk of an aggressive credit crunch may have receded, a lasting solution to the Euro problem requires ample liquidity to reverse contagion (and oil the wheels of structural change) and a strategy to renew growth across the region. It remains doubtful if the member countries have the will or ability to achieve this.**

Comments or feedback are always welcome at [theblog@witan.co.uk](mailto:theblog@witan.co.uk)

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