The Eurozone's *Autumn Hangover*

And the chance of a breakup.

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After a summer of Europeans forgetting their woes and tanning themselves at the beach, the time for a reality check has come, for the fundamental problems of the eurozone remain unresolved.

First, a trillion-dollar bailout package in May prevented an immediate default by Greece and a break-up of the eurozone. But now sovereign spreads in the peripheral eurozone countries have returned to the levels seen at the peak of the crisis in May.

Second, a fudged set of financial "stress tests" sought to persuade markets that European banks needed only €3.5 billion in fresh capital. But now Anglo-Irish alone may have a capital hole as high as €70 billion, raising serious concerns about the true health of other Irish, Spanish, Greek, and German banks.

Finally, a temporary acceleration of growth in the eurozone in the second quarter boosted financial markets and the euro, but it is now clear that the improvement was transitory. All of the eurozone's peripheral countries' GDP is still either contracting (Spain, Ireland, and Greece) or barely growing (Italy and Portugal).

Even Germany's temporary success is riddled with caveats. During the 2008–09 financial crisis, GDP fell much more in Germany—

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because of its dependence on collapsing global trade—than in the United States. A transitory rebound from such a hard fall is not surprising, and German output remains below pre-crisis levels.

Moreover, all the factors that will lead to a slowdown of growth in most advanced economies in the second half of 2010 and into 2011 are at work in Germany and the rest of the eurozone. Fiscal stimulus is turning into fiscal austerity and a drag on growth. The inventory adjustment that drove most of the GDP growth for a few quarters is complete, and tax policies that stole demand from the future ("cash for clunkers" all over Europe, and so forth) have expired.

The slowdown of global growth—and actual double-dip recession risks in the United States and Japan—will invariably impede export growth, even in Germany. Indeed, the latest data from Germany—declining exports, falling factory orders, anemic industrial-production growth, and a slide in investors' confidence—suggest that the slowdown has started.

In the periphery, the trillion-dollar bailout package and the non-stressful "stress tests" kicked the can down the road, but the fundamental problems remain: large budget deficits and stocks of public debt that will be hard to reduce sufficiently, given weak governments and public backlash against fiscal austerity and structural reforms; large current-account deficits and private sector foreign liabilities that will be hard to roll over and service; loss of competitiveness (driven by a decade-long loss of market share in labor-intensive exports to emerging markets, rising unit labor costs, and the strength of the euro until 2008); low potential and actual growth; and massive risks to banks and financial institutions (with the exception of Italy).

This is why Greece is insolvent and a coercive restructuring of its public debt is inevitable. It is why Spain and Ireland are in serious trouble, and why even Italy—which is on relatively sounder fiscal footing, but has had flat per capita income for a decade and little structural reform—cannot be complacent.

As fiscal austerity means more recessionary and deflationary pressures in the short run, one would need more monetary stimulus to compensate and more domestic demand growth—via delayed fiscal austerity—in Germany. But the two biggest policy players in the eurozone, the European Central Bank and the German government, want no part of that agenda, hoping that a quarter of good GDP data makes a trend.

The rest of the eurozone is in barely better shape than the periphery: the bond vigilantes may not have woken up in France, but economic performance there has been anemic at best, driven mostly by a mini-housing boom. Unemployment is above 9 percent, the budget deficit is 8 percent of GDP (larger than Italy's), and public debt is rising sharply. Nicolas Sarkozy came to power with lots of talk of structural reforms. He is now weakened even within his own party, and lost regional elections to the left (the only case in Europe of a shift to the left in recent elections). Given that he will face a serious challenge from the Socialist Party candidate—probably the formidable Dominique Strauss-Kahn—in the 2012 presidential election, Sarkozy is likely to postpone serious fiscal austerity and launch only cosmetic structural reforms.

Belgian Prime Minister Yves Leterme, as current holder of the rotating EU presidency, now speaks of greater European policy unity and coordination. But Leterme seems unable to keep his own country together, let alone unite Europe. Even Angela Merkel—in growing Germany—has been weakened within her own coalition. Other eurozone leaders face stiff political opposition: Silvio Berlusconi in Italy, whom one hopes may soon be booted out of power; José Luis Rodríguez Zapatero in Spain; George Papandreou in Greece. And politics is becoming nationalistic and nativist in many parts of Europe, reflected in an anti-immigrant backlash, raids against the Roma, Islamophobia, and the rise of extreme right-wing parties.

So a eurozone that needs fiscal austerity, structural reforms, and appropriate macroeconomic and financial policies is weakened politically at both the EU and national levels. That is why my best-case scenario is that the eurozone somehow muddles through in the next few years; at worst (and with a probability of more than one-third), the eurozone will break up, owing to a combination of sovereign debt restructurings and exits by some weaker economies. ◆