A way out of the woods

The euro may survive brinkmanship over Greece, but the road to recovery will be long and hard

LAST year every new jolt in the euro crisis sent financial markets into a spin. This year they have become blase. They barely even registered the torching of buildings in Athens, nor the last-minute cancellation of a meeting of ministers that was supposed to agree on a new aid package for Greece.

Although a calm is welcome, nonchalance is not justified. A deal probably will be done on Greece, and there are promising signs of reform all over the continent. But, the problems ahead for the euro zone remain huge. The crisis is, in effect, moving from an acute to a chronic phase.

Will Athens buckle?

The latest hiccup in Greece was caused by European finance ministers' determination to get Greek leaders to commit themselves to changing their ways. While riots exploded on the streets of Athens, the Greek parliament approved yet another programme of austerity and reform. The finance ministers were then due to agree on a new €130 billion ($170 billion) bailout which is meant to clear the way for a private-sector debt-restructuring that would leave Greece owing around 120% of G D P in 2020, down from today's 160%. But an election is looming in April, and Greece's rescuers insisted that the country's main political leaders should all sign up to the package.

For all the bile that some are now hurling, especially at Germany, the odds are that Greece's politicians will buckle. Few in Athens want a disorderly default next month that might lead to a messy exit from the euro. Nor, despite sharp words from some German politicians, do most in the rest of Europe.

Elsewhere in the euro zone there are glimmers of hope, especially in the ambition for structural reforms. In the euro's first decade, southern Mediterranean countries enjoyed the benefit of lower interest rates, but they failed to reform their labour and product markets to make their economies more competitive for a world in which they had lost the safety-valve of currency devaluation.

Belatedly, the euro crisis has changed this. Ireland has regained competitiveness. Spain's new government won a big mandate for radical change last November. It has announced reforms of its rigid labour laws that may eventually go a long way towards cutting the country's chronically high unemployment. And Italy's new prime minister, Mario Monti, although running an unelected government, basks in the highest popularity rating of any Italian leader in years. Mr Monti has already passed a pension reform and is soon to propose labour reforms of his own (see page 54). All this should make euro-zone members better able to cope with the rigours of sharing a single currency with Germany.

Yet the continuing frailty of the euro zone's economies threatens to undermine these efforts. The latest numbers, for the fourth quarter of 2011, show Greek G D P shrinking by as much as 7% a year. Ahead of an election that may bring the centre-right to power, this is making the politics of austerity still more vicious (see page 53). It also sets up the eventual prospect of yet another debt restructuring. And although a new government may successfully impose wage and public-sector payroll cuts, Greece's privatisation promises look hopelessly optimistic. Deeper reforms to the economy may prove to be beyond its politicians' capacity, even if they keep their word (which past form suggests they will not).

Italy, Spain and Portugal will all see a sharp fall in G D P this year. The euro-zone economy as a whole may now be shrinking, after G D P fell in the fourth quarter (see page 73), and the fiscal compact imposed by Germany is geared towards ever more austerity. These fears spill over into the bond markets, as this week's downgrades by Moody's, a ratings agency, have underlined. Although investors have become more optimistic about Spain and Italy, they remain worried about Portugal.

The chronic lack of growth threatens to poison politics, which has now become the greatest danger of all for the euro. Europe's voters have so far been surprisingly stoical, but they will surely rebel if no light is in sight. Where economies are shrinking, people will have to endure even more pain—some of it imposed by diktats from Brussels and Berlin.

Although structural reforms may boost long-term growth prospects, they take years to bear fruit. In the short term they can raise unemployment and reduce incomes. Groups which have been protected from competition are likely to fight, sometimes violently, to keep their perks and privileges. The promoters of two previous labour-market reforms in Italy were both assassinated. Elections loom not just in Greece but also in France in April this year and in Italy in early 2013. The political weather in any of these countries could change overnight.

Reform in Germany, too

Two moods are competing in Europe: the feeling of injustice that set Athens ablaze last weekend, and the gathering sense of progress as governments act to make economies more competitive. The euro's fate will be determined by which prevails.

There are ways to give progress an encouraging push. Leaders need to loosen monetary policy to stimulate demand, to continue work on the euro-zone firewall and to set up some form of debt mutualisation that would lower the cost of servicing the debts built up during the bubble years. And creditors-especially Germany (see page 56)-as well as debtors need to embrace reform. Services, which account for two-thirds of Europe's economies, remain both less developed and less traded than they should be. A recent World Bank report estimated that liberalisation and completion of a single European market in services could lead to a tripling of trade. It also pointed to a boost to growth from liberalisation of Europe's heavily protected agriculture. But making these changes requires courage and effort from politicians.

Sentiment about Europe has improved, and that is welcome. So is the greater sense of political direction. But as the immediate danger to the euro recedes, another looms: that the urgency which has driven progress so far dissipates. That must not happen. Europe is on the road to recovery, but the way is long and dark. ■

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