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Titanic-Style Problems for Euro Zone

- By IRWIN STELZER



On the surface, things are looking up in the euro economy. But remember, economies in some ways resemble icebergs. And seven-eighths of icebergs —the lethal, unseen part— are below the surface.

No denying that the view from the surface is pleasant. Euro zone economic sentiment, reports the European Commission, hit a 28-month high in July. Little wonder: Markit reports that the area's retail sales rose in July for the second consecutive month and at the fastest rate in two years, driving employment in that sector up for the first time since March 2008. The area's output picked up in both the service and manufacturing sectors, with manufacturing leading the way.

As usual, Germany is the locomotive. With its consumers holding to their historical stinginess, exports remain the main driver, causing unemployment in July to drop for the 13th consecutive month. At 7.6% it is lower than it has been since November 2008. In fact, the 20,000 drop in unemployment brought the total to just about where it was before the recession hit.



Getty Images

German exports remain the euro zone's driving force.

France is doing its bit. According to Markit, an expanding service sector is increasing French private sector output "at a strong pace," and employment growth in that sector rose in July for the third consecutive month. And outside the euro zone Britain seems to be adding a bit of optimism to European-wide sentiment: The U.K. economy grew 1.1% in the second quarter from the first quarter—or an annual rate of about 5%—twice what forecasters had predicted and the fastest rate in more than four years.

So much for what is obvious to the analyst's naked eye. Look below the surface and we see something very different. Spain provides a good example. Most of the news has been about that country's so-called successful return to the international bond market (never mind the premium paid over German bunds). A surface glance suggests that Prime Minister José Luis Rodríguez Zapatero's Damascene conversion to austerity has Spain on the path to fiscal rectitude. Unfortunately, dig down and we find that Spain's 17 regional governments spend twice what the national government does, are nearly \$200 billion in debt according to Bloomberg, and will have to tap the markets for \$57 billion this year, for which they will pay an even stiffer premium than the national government. That means that the growth-

reducing effect of Mr. Zapatero's austerity plan will be aggravated by cuts at the regional level.

There are other examples of what Jennifer McKeown, senior European economist at Capital Economics, calls "stark divergences between countries." To cite just two: While retail sales in France and Germany rose in the second quarter, sales in Italy fell. And while Germany heads towards fuller employment, the unemployment rate in the euro zone as a whole hovers around 10%.

These divergences conceal a fundamental, unsolved problem in the euro zone economy—its outsize dependence on the German export machine. That machine is now at risk of a real slowdown. Markets in the periphery of Europe are shrinking as austerity replaces deficit-financed bingeing on imports. Asian markets are showing signs of slowing, especially in China, an important outlet for German goods. And the American recovery is losing momentum, further reducing demand for imported goods. Add to that the 8% rise of the euro against the dollar in July, and you have a German economy more rather than less likely to slow in the second half of the year, and with it all of euroland.

Then there are Europe's banks. It is now clear that contrary to claims by their sponsors the stress tests were hardly stressful, that overvalued assets remain on balance sheets, and that dicey sovereign debt was ignored. Barclays estimates that if sovereign debt had been properly considered, 22, not the reported seven banks would have failed the tests, and that the sector needs to raise €12.6 billion (\$16.4 billion) in capital, a lot more than the €3.5 billion estimated by the eurocracy. It is far from certain that investors will make such capital available on bearable terms,

in which case more bailouts by already-grumpy German taxpayers will be needed.

So, look below the surface of the glowing reports on the stress tests and it is clear that the piper has yet to be paid. Which didn't deter the European Central Bank last week from tightening the terms on which it will lend to banks in need of funds, further dampening growth prospects.

The basic structural deficiency of the common currency area—a single currency with multiple national fiscal policies—is too often mentioned to warrant expanded treatment here. It might well constitute the largest part of the submerged portion of the iceberg towards which the good ship euroland is headed. Unless the iceberg melts, in which case, according to Canadian Geographic magazine, "it makes a fizzing sound... [which] comes from the popping of compressed air bubbles." Not all that different from a financial meltdown.

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