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Europe's real problem: a lack of growth

By Fareed Zakaria, Published: October 12

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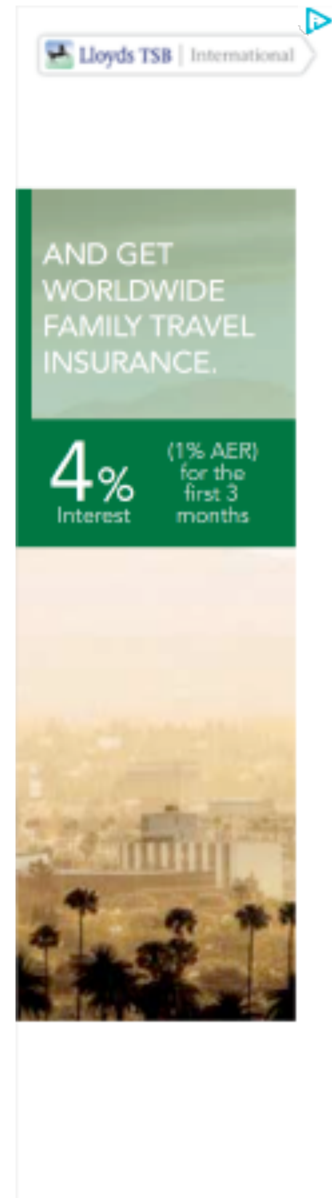
Europe is facing its most severe challenge since 1945. If the Greek crisis morphs into an Italian crisis, the entire structure of post-World War II Europe could unravel. Finally, European leaders seem to recognize that their strategy of kicking the can down the road has not worked. The result will not be a dramatic solution — that is not how Europe works — but, more likely, a series of steps that together will be more comprehensive than anything done before. Still, they will not address Europe's core problem: a lack of growth.



It is an irony of history that the crisis has placed Germany firmly at the helm of Europe's affairs. France conceived, planned and pushed for the continent to have a single currency, largely to dilute the influence of Germany, its central bank and its currency. But economic realities have proved stronger than organizational structures. Germany is by far Europe's biggest economy and is in sound fiscal health. That makes it the only country that can write checks or issue guarantees that markets take seriously.

German Chancellor Angela Merkel has been criticized in many quarters for not endorsing a big-bang solution — something like euro-bonds, which would, in effect, extend a German guarantee for the debt of all euro-zone countries. But any such solution would allow countries such as Greece and Spain to borrow again at "German" interest rates (which are much lower than they could get on their own), meaning that these countries would have no incentive to cut their budget deficits and implement reforms to spur economic growth.

A few weeks ago, we got a glimpse of Germany's nightmare scenario: Markets began focusing on Italy and its debt became expensive. The European Central Bank intervened, buying Italian bonds, which lowered rates at which Rome could borrow. As soon as the situation stabilized, Italy's prime minister, Silvio Berlusconi, began watering down his commitments to enact economic reforms.

German officials are determined not to end up with a situation in which Greece, Spain, Italy or other troubled countries can avoid the hard work of restructuring their budgets because that would ensure that this crisis recurs — and the next bill will be bigger.

Europe faces two sets of problems. First, some of its governments have too much debt. Second, this debt is held by important European banks, which themselves face dangers as investors realize how much bad debt is on their books. Banks will be forced to raise capital to offset these loans. For Greece, some kind of default is inevitable, but it won't be called that. Going forward, there is likely to be some kind of bond insurance that will at least partly guarantee the debt of euro-zone countries. Though an imperfect solution, this would keep some pressure on countries with high debt loads while ensuring that the burden is not crippling. Additional pressure can be maintained — and additional funds raised — if the International Monetary Fund partners in these efforts.

Ultimately, however, Europe's crisis is one of growth. The problem is not so much that Greece has been unwilling to make sacrifices. It has made many. But Greece's budget numbers look bleak because its growth forecast looks bleak. It needs to address a much larger question of competitiveness. What can the Greek economy do to attract capital and investment? And at what wage levels? These are questions most European countries will need to answer to fully solve their problems. Italy's economy has not grown for an entire decade. No debt restructuring will work if it stays stagnant for another decade. Even Germany is not immune, with an average growth rate of only 1.5 percent. German officials know that, with a declining population, in five to seven years the country is likely to grow at an annual rate of just 1 percent. That's not much of an engine for Europe.

Europe needs a crisis agenda to get out of its bind, but beyond that it needs a growth agenda, which involves radical reform. The fact is that Western economies — with high wages, generous middle-class and political subsidies, and complex regulations and taxes — have become sclerotic. Now they face pressures from three fronts: demography (an aging population), technology (which has allowed companies to do much more with fewer people) and globalization (which has allowed manufacturing and services to locate across the world). If Europe — and, for that matter, the United States — cannot adjust to this new landscape, it might escape this storm only to enter another.

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