

After the downgrades comes the downward spiral

di Wolfgang Münchau

At the end of a briefly euphoric week, reality caught up.

On one level, Friday's news was not really surprising. The French rating downgrade was a shock foretold. As was the breakdown in talks between private investors and the Greek government about a voluntary participation in a debt writedown. A proposition that was unrealistic to start with has been rejected. We should not feign surprise.

And yet both events are important because they show us the mechanism behind this year's likely unfolding of events. The eurozone has fallen into a spiral of downgrades, falling economic output, rising debt and further downgrades. A recession has just started. Greece is now likely to default on most of its debts and may even have to leave the eurozone. When that happens, the spotlight will fall immediately on Portugal, and the next contagious round of downgrades will begin.

Europe's insufficient rescue fund, the European Financial Stability Facility, now also faces a downgrade because it had borrowed its ratings from its members. The way the EFSF is constructed means that its effective lending capacity will thus be reduced. Even though the French downgrade did not come as a surprise, the eurozone member states have no plan B for this, just a few stopgap emergency scenarios. They may decide to run the EFSF and its permanent successor concurrently. They may also provide the latter with a full immediate allotment of its capital. But this will create gaps in national budgets in a bad year.

By downgrading France and Austria but not Germany and the Netherlands, Standard & Poor's also managed to shape expectations of the economic geography of an eventual break-up. A downgrading of all triple A rated members would have been much easier to deal with politically. Germany is now the only large country left with a triple A rating. The decision will make it harder for Germany to accept eurozone bonds. The ratings wedge between France and Germany will make the relationship even more unbalanced.

The immediate gut reaction to Friday's news is also a reminder that the crisis and its resolution are taking place in parallel universes. Angela Merkel's comment that the EU should now quickly complete the fiscal treaty is a typical example of that disconnect. No matter what happens, fiscal discipline is their answer. The crisis response fails to recognise the overarching role of the private sector in the eurozone's internal imbalances. The conclusion of the fiscal treaty, which is the top priority of EU politics right now, is at best an irrelevant distraction. Most likely, it will enhance the trend towards pro-cyclical austerity of the kind we have seen in Greece. I also expect to see the EU administer a dose of regulatory revenge against the rating agencies. Justified or not, this too is a distraction.

I argued a while ago that the December summit was the last chance for a comprehensive systems reboot. Back then, one could have envisaged a grand bargain that combined a joint eurozone-level

budget, a eurobond, a policy regime to address intra-eurozone imbalances and, in this context, also hard national budget constraints. Ms Merkel and her acolytes in Berlin and Brussels celebrated the outcome of the December 8-9 summit as a victory because it included none of the above, except the budget balancing component.

Now that she has got everything she wanted, the system continues to unravel. With each turn of the spiral, the financial and political costs of an effective resolution increase. We have moved past the point where electorates and their representatives are willing to pay the ever-rising costs of repairing the system. Last week a couple of senior parliamentarians from the ruling CDU party, whom I had previously considered voices of moderation, argued that a Greek exit from the eurozone would not be such a big deal. Expectations are changing quickly, and so is the acceptance of a violent ending.

And no, the European Central Bank's huge liquidity boost is not going to fix the problem either. I do not want to underestimate the importance of that decision. The ECB prevented a credit crunch and deserves credit for that. The return of unlimited long-term money might even have a marginal impact on banks' willingness to take part in government debt auctions. If we are lucky it might get us through the intense debt rollover period this spring. But a liquidity shower cannot address the underlying problem of a lack of macroeconomic adjustment.

Even economic reforms, necessary as they may be for other reasons, cannot solve this problem. This is another European illusion. We are now at a point where effective crisis resolution would require a strong central fiscal authority, with the power to tax and allocate resources across the eurozone. Of course, it will not happen.

This is the ultimate implication of last week's ratings downgrades. We have moved beyond the point where a technical fix would work. The toolkit is exhausted.