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The eurozone will cast a lengthening shadow in 2012

Sadly, the eurozone’s uncertain future will continue to cast a huge shadow over the global economy next year. Surely there are other concerns, including the risk of a not-so-soft landing in China, of pre-electoral paralysis in the US, and of a large, unexpected geopolitical shock. Even in the most benign scenario, the massive overhang of global public and private debt will hinder any robust recovery in the advanced economies. But the eurozone remains far and away the greatest source of vulnerability.

There is no easy solution. The eurozone needs a new constitution that creates powerful, centralised fiscal and regulatory authorities, with corresponding political integration. Substantially greater integration probably means ousting some of the less developed states until they are sufficiently economically advanced. Unfortunately, such a course is politically unacceptable, not least to France, a core member.

Therefore the only realistic medium-term solution is an expansive interpretation of the European’s Central Bank’s charter, ideally prefaced by a huge restructuring of public and or private debt in several periphery countries. The ECB is understandably nervous of losing vast sums by pouring money into a leaky bucket, especially without an automatic fiscal backstop vast enough to absorb losses. Germany, in turn, is understandably worried about having to pay a disproportionate share of any future recapitalisation, not to mention about being gamed into tolerating much higher inflation as a back-door solution.

To make matters worse, the upshot of the latest EU negotiations seems to be that private sector burden-sharing is off the table for everyone but Greece. This is an absurd...
position if there ever was one. A system that does not allow for bankruptcies is no system at all.

The euro problem could still be fixed in the medium term with a combination of tough debt and economic restructuring in the periphery, combined with very expansive central bank policy. An implicit northern Europe debt backstop could prevent inflation exploding, at least for a while. Ideally a few weaker countries would leave the single currency, to regain competitiveness and pave the way for tighter union among the rest. The long run consequences might not be pretty, and the eurozone would still need a new constitution to avoid perpetual stagflation.

For now, 2012 looks set to be another year of floundering towards an uncertain future for the euro-system.

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