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The euro area

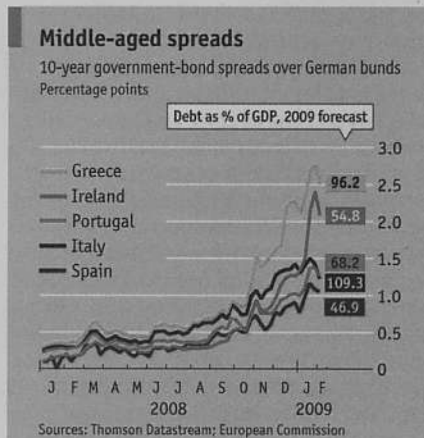
A tricky balancing act

The euro area economy's vaunted strengths are starting to look like weaknesses

A YEAR ago, when the financial crisis was in its infancy, the euro area enjoyed a brief moment in the sun. Its peers in the rich world—including Britain, the largest European Union economy outside the euro—had enjoyed faster growth and lower unemployment but now looked vulnerable. Britain was everything a country should not be in a credit crunch: debt-ridden, reliant on foreign savings, chock-full of banks and estate agents, and short of firms that made tangible stuff. America ticked many of those boxes too. In contrast, Europe's past vices now seemed like virtues: rigidity recast as solidity, risk-aversion as prudence. When the crisis got worse in the autumn, the euro was a shelter for its members from the storms.

It is clear that America and Britain are indeed suffering badly. But so now is all of the rest of Europe. Figures due out on February 13th are expected to show that euro-area GDP shrank at an annualised rate of around 5% in the fourth quarter of 2008, worse even than the grim numbers from America, although not quite as bad as those for Britain. Business indicators have stabilised but this suggests only that the economy is likely to shrink at a similar rate in the current quarter, not that activity has stopped falling. The IMF forecasts that euro-area GDP will decline by 2% this year and barely recover in 2010.

More irksome still is that profligate America is able to borrow on better terms. Despite a sell-off (see page 65), the yield on a ten-year US Treasury bond is still half a percentage point lower than that on a German bund, which comes from the euro-area's most creditworthy country. Yields are lower partly because the Federal Reserve has driven America's short-term interest rates close to zero. It may yet buy up government bonds to push down long-term interest rates as well. The European Central Bank (ECB) is reluctant to go down that path, partly for fear that it might be seen to be bowing to political pressure. It is chary about more monetary stimulus of the normal kind, too: as *The Economist* went to press, it was expected to keep its benchmark interest rate at 2%.



For some governments, the ECB's foot-dragging is not the biggest worry. A greater concern is the extra reward that bond markets are demanding to hold their debt. Before the credit crunch, investors seemed scarcely less keen to lend to Italy than to Germany. Germany's ten-year bunds yielded as little as 0.2 percentage points less than the equivalents for Italy, despite a smaller public-debt burden. But that spread—like those of Ireland, Greece, Spain and Portugal—has widened (see chart).

Adding to the strains, Standard & Poor's, a credit-rating agency, has recently downgraded Spain, Portugal and Greece, and issued a warning that Ireland's public debt may lose its triple-A stamp. The odds of a sovereign-debt default have shortened, making other risks seem less improbable as well. Might the euro crack apart? The jump from possible default to break-up is a big one. And any country that had trouble financing itself within the euro would surely find life outside even less hospitable. Yet such talk shows just how troubled the euro countries now are.

In truth many of the euro area's supposed strengths were always more apparent than real. At the start of the financial crisis, there was much talk of the absence of "imbalances" in the euro area—unlike America, which had (and has) to borrow so much abroad. Yet the euro's external balance concealed a huge internal divide between places like Germany, with excess savings, and countries such as Spain and Greece, with huge current-account deficits. Such countries are most exposed in a credit drought, as they rely on foreign capital. So the hope had been that weaker demand in deficit countries would be offset by faster spending from hitherto prudent German ▸▸

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firms and consumers.

Unfortunately, the instinct to save grows stronger in a downturn. The response of German firms to weaker export demand has been to cut investment plans. Consumers are warier too. So Germany's reliance on foreign demand has proved more of a drag even than other countries' reliance on foreign savings. The IMF forecasts that GDP will shrink more this year in Germany than in France, Italy or Spain.

The manufacturing bent of the big euro-area economies has also left them looking cumbersome rather than strong. Goods producers are hit hardest in downturns: consumers are more likely to defer spending on big-ticket items, such as cars and home appliances, than on the frequent small purchases that keep service industries ticking over. And firms are loth to lay out for plant and machinery—a German niche—when demand is so uncertain.

For all the pain endured by companies and the big drop in euro-area output, the region's unemployment is rising more slowly than in America or Britain. One argument is that Europe's tendency to hoard jobs in downturns may be a boon. Forced layoffs can feed a downward spiral of weaker spending and job losses. But recovery is also more likely to be delayed if weak firms in overstaffed industries are too slow to shed workers. So far, joblessness has risen a lot mainly in Spain and Ireland, because of their large layoffs in the construction industry. But there are signs that job losses are accelerating in France and Germany as well.

What default might look like

To some, the boast last autumn that the euro is a haven from financial storms was hubristic. The sharp rise in bond spreads for Greece, Italy, Ireland, Portugal and Spain shows that capital markets are now less forgiving of high public debt or rising budget deficits. It is likely, however, that borrowing costs would be even higher if any of these countries were outside the euro area, since an extra premium would then be required to compensate investors for currency risk. Italy's public debt is more than its annual GDP, yet it can still borrow for ten years at around 4.6% a year. It needs to raise €377 billion in capital markets this year, according to a report by Fitch, another rating agency, equivalent to some 23% of GDP, a huge number (though it has had to raise even more in the past).

One reason for rising credit spreads is the huge stock of bonds in the pipeline. Almost €2 trillion of public debt has to be raised by the euro area, Britain and Switzerland this year, equivalent to 17% of their combined GDP. Ireland alone needs about €47 billion to cover its yawning budget deficit, its bank bail-outs and to pay off maturing debts (see story on next page). With so much supply to be absorbed by finicky markets, there is a worry that some bonds may go unsold. Yet that risk is easy to overstate, says Brian Coulton at Fitch, because there is little competition for funds from private borrowers. Even a failed bond auction need not be a disaster. Countries have liquid reserves to tide them over while they reprice bonds, says Mr Coulton.

Bond investors might still take fright if there is an unexpected rush of new borrowing—for a fresh bank bail-out, say. Were markets to lose patience, a country could for a while arm-twist local banks into buying its debt, though that would curb other loans, hurting the economy. But it cannot ask the central bank to tide it over. The ECB is forbidden from buying debt directly from governments (though it can intervene in bond markets). Eventually the only option might be to default on maturing bonds. This need not imply exit from the euro; the political, budgetary, economic and legal costs of such a course are too high for it to be sensible.

More likely, a failure to pay off a loan on time would trigger a rescue package, perhaps led by the IMF but financed by richer EU states. It would be a messy business that would harm all euro members, says Daniel Gros of the Centre for European Policy Studies, a think-tank in Brussels. He believes the prospect of default is small. But since it could have such big costs, it might be safer to be prepared for it. ■

Food in France

Sandwich courses

PARIS

Faster food replaces the leisurely lunch

AS THE recession bites, a gastronomic indignity is nibbling its way through the land of fine dining: the humble sandwich. Last year the French munched their way through 1.3 billion sandwiches, 50m more than in 2007, according to GIRA Foodservice, a consultancy. The traditional sit-down lunch with the *plat du jour* at the local brasserie is, it seems, under threat. In 2008 bankruptcies of restaurants and cafés, affected also by the smoking ban, leapt by 26%. Is the global slump turning a nation of civilised lunchers into one of convenience snackers?

Even before the downturn, the French had acquired a taste for the sandwich. Between 2003 and 2008, the market jumped by 28% in volume. It is now worth some €4 billion ($5.1 billion) a year. This includes the triangles of bread favoured by the British and the French version made with a baguette. In recent years, boutique sandwich bars, offering such fillings as foie gras with onion confit, have spread across the business districts of Paris, attracting long lunchtime queues. Chains such as Paul, Lina's (slogan: *le beautiful sandwich*) or Dailymonop' have also taken root.

The young seem particularly keen, even (*quelle horreur!*) eating the things at their desks. The average 25-34-year-old consumes twice as many sandwiches every year as does a 45-54-year-old, says Raphael Berger, at the Research Centre for the Study and Observation of Living Conditions. Working women like *le sandwich*, says Jean Rossi at GIRA Foodservice. It "leaves them time to do other things, like going shopping, during their lunch hour too."

Now, the downturn has produced another reason: price. The upmarket *sandwich gastronomique*, at €8 a shot, may be holding up, but the cheaper end looks likely to grow faster. In January a new sandwich chain called Goûtu (a play on the word goût, or taste) opened in Paris, designed for the budget era. It offers sandwiches for as little as €1, calling them an "economical alternative".

The French seem hooked. Next month, Paris will host the European Sandwich and Snack Show. Chefs from around the world will compete for the "Sandwich World Cup". On six previous occasions, no French chef has ever won. Thanks to a fresh challenge from the lowly sandwich, the country's gourmet reputation is now on the line.

So farewell then, plat du jour