Europe: heavy weather heads this way
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Events in Europe this week point to a rapid end game for Greece in the euro zone. While the underlying economics have been driving Europe towards an inevitable restructuring of the single currency, the timing is being driven by politics.

The move towards anti-austerity in France, Greece and elsewhere means that the requirements for plan A – making crisis countries adjust to lower debt levels through fiscal contraction and debt write-offs, with a firewall provided by the European Central Bank – cannot work. The problem is that everything inside the firewall could sustain unnecessary burns.

Lack of competitiveness in southern Europe and the inability of countries to endure fiscal austerity under a fixed exchange rate will cause serious damage and negative growth. The European banking system cannot withstand this event without substantial bank recapitalisation. The lack of real adjustment has made the problem worse as every month has passed without governments recognising the fundamental problems.

One crucial issue, especially for Australia, is the spillover we can expect from a crisis in Europe to the rest of the world. Direct trade spillovers are negative because a weaker Europe means fewer imports by Europe and so fewer exports to countries outside Europe.

Another problem is that because European banks finance 80 per cent of world trade, a European banking crisis may cause not only a freezing of debt markets, but also a sudden cessation of the finance of global trade. This must be avoided at all costs. We can only hope the IMF and national governments already have a plan for this situation.

Spillover through balance sheet linkages across countries is also likely to be important, although perhaps less important than they were directly after the Lehman Brothers' collapse in 2008.

Surely counterparty risk is better understood today, given this crisis has been expected for the past two years. Perhaps there will be fewer surprises in the global financial system compared with the global financial crisis, but there is still a risk that the financial problems discovered in 2008 are not resolved.

A third major spillover channel is direct contagion through a loss of confidence in the global economy. This is likely to be sharply negative and will cause problems for countries such as Australia where the currency has conventionally been a risk play. Australia's consumers are more pessimistic than most, and the current state of federal politics makes this worse.

A fourth spillover channel is positive for non-European economies. This is the reallocation of capital from Europe to elsewhere in the global economy. If this capital can be absorbed it will be a shift from negative return activities in Europe into high-return activities, particularly in emerging economies.

This effect emerges strongly in modelling of the crisis scenario in Europe. If the loss of confidence disappears quickly, global trade financing continues, and financial markets keep functioning, the rebound in Asia and Australia within a year of the crisis could be substantial.

Overall there are many more negatives from a European crisis in the short term, but the effects for Australia are likely to be positive in the medium term. This depends crucially on what happens in Asia, but China is in a good position to respond to the crisis domestically. It also depends on which policies Australia follows.

Right now, the Australian economy faces a perfect storm. The federal government has bet that a crisis in Europe will not happen during the 2012-13 financial year.

The financial year starts on July 1, when a carbon tax set four times above the world price begins to raise input costs, particularly energy costs. No amount of compensation changes the economic negativity of this shock.

At the same time, the budget seeks to turn the fiscal position around by up to 4 per cent of gross domestic product within one year. This is touted as a record adjustment.

It is likely that the timing and scale of both of these economic reforms could not have been worse. Hopefully, the national interest will dominate the need to keep some highly risky political promises.

There are important lessons for Australian policymakers from this episode. One is not to lock in government outlays based on forecast revenue streams that are highly uncertain. Another is not to design domestic policies that rely on the outcome of highly uncertain political processes in the global economy, particularly when it comes to climate change.

Unsound political decisions have put the global economy into a dangerous position. Australia has wandered aimlessly down this same path thanks largely to a minority government. In the wash-up of events over the next several years, one hopes that some of those responsible for putting Australia unnecessarily in the eye of a perfect storm are held to account.