THE G-20 SUMMIT ASSESSES THE EUROPEAN CRISIS: FINDING THE WAY FROM TORONTO

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Last September in Pittsburgh, G-20 leaders were so thrilled with an emerging global recovery spurred by their unprecedented concerted and coordinated action that they pledged the G-20 as "the premier forum for international economic cooperation."

A U-TURN IN THE G-20 CONSENSUS?

Yet only a few months later, the pledge began to falter in light of the ongoing European crisis. As the recent meeting in Busan confirmed, now two separate views are taking shape among the G-20. The first—championed by the U.S.—considers fiscal policy to be a fundamental growth stimulus in the face of continued uncertainty surrounding the pace of private demand. The second—favored by Europeans—is one of increasing concern that growth-supportive fiscal policy may in fact prove to be a destabilizing factor, fueling adverse market reactions that would compromise debt sustainability.

Against the backdrop of the ongoing European crisis, there are signs, if still relatively concealed, of rising tensions in world capitals sparked by fears that the crisis may get out of hand and trigger an economic and financial turmoil too severe for a still fragile global economy to weather. In the U.S., these concerns are escalated by the jobless recovery that the latest data confirms and by the announced compensatory measure of expanding U.S. exports in the coming years.

A feeling shared by all the members of the G-20, including the Europeans, is frustration that the European crisis is far from a textbook case. It is unfolding against an incomplete institutional framework, showing the European Union—the largest economy in the world—to be ill-equipped to manage the first serious crisis since its post-World War II establishment.

IMPLICATIONS FOR THE U.S.

The meeting of the G-20 finance ministers in Busan a few weeks ago resulted in no easy way out. Meanwhile, the stakes continue to increase, especially for the U.S., which needs at the very least a stable if not a growing Europe to consolidate its own recovery. The medium-term repercussions of a weaker euro and the resulting decrease in U.S. exports to Europe is not the only issue to contend with. There will also be repercussions for U.S. manufacturers in the international markets who will be affected by the increased competitiveness of European exporters.

Two additional complicating factors could give rise to rough times ahead in the short term. First, the political climate in Washington could become easily overheated as an appreciated yuan against the euro offers Chinese policymakers the chance to delay any adjustment of their exchange rate policy vis-à-vis the dollar—an issue which has recently taken on a high level of political relevance in Washington. The second factor is the "contagion" to the still fragile U.S. banking system should the European financial system face heavy pressure as a result of the ongoing crisis.

WEIGHING THE OPTIONS

Why has the G-20 not yet fully recognized the systemic implications of a potential full-blown European crisis? First, because the Europeans themselves have been late in doing so. Second, because there has been wishful thinking for too long that the crisis in Greece or even Portugal or Spain would not necessarily spread to the rest of the European Union. Clearly, this is wrong. Not only is the E.U. heavily integrated, but many European countries share the common vulnerabilities of belonging to a monetary union whose incomplete institutional framework increases their defenseless exposure to a speculative attack.

The G-20 is not a decision-making forum but a high-level consultative body. Leaders will therefore use the summit in Toronto to put pressure on the Europeans to come together and resolutely solve their own problems. The recently-announced initiative on the European Stabilization Mechanism would certainly go in the right direction if given full operational content, but it stands too far from offering a convincing response to the current problems.

Ultimately, any crisis of confidence in the ability of the European economy to sustain its debt reflects a lack of confidence in its ability to grow again. By focusing only on fiscal stabilization, the Europeans risk validating the fears of the financial markets unless they start moving forward with an aggressive and credible plan to boost growth, removing the various barriers and regulatory obstacles in the way.

Apart from moral suasion, there is not much else that other countries can do as it is fully in the hands of the Europeans. They should be mindful, however, that no announcement will be ever credible enough, no financial safety net ever strong enough, no financial package ever big enough, if European leaders continue to qualify their pledges of support. A credible European Union means they must stand together, whatever it takes and come what may.