Don't Bet on *Decoupling*

Why a U.S. slowdown is bad news for Europe.

BY MELVYN KRAUSS

The fact that the U.S. economy is slowing is bad news for Europeans no matter what claims are made that Europe's economy has successfully decoupled from that of the United States. Decoupling is a silly idea, based on bad economics—and on some Europeans' reluctance to accept the fact that Europe's short but sweet economic expansion is coming to an end.

Yes, the U.S. market has become less important for European exports, while Asia's trade significance for Europe has grown. So what? Trade is but one of many linkages between the U.S. and European economies that matter. In today's inter-connected global economy, uncertainty about the U.S. economic outlook increases one day, and Dutch consumer confidence, for example, takes a tumble the next.

The links between Europe and America are, frankly, much more complex than the advocates of decoupling appreciate.

The Federal Reserve, for example, is aggressively cutting interest rates in the United States to forestall a possible recession. As a consequence, the euro is rising not only against the U.S. dollar—it also is rising against the Asian currencies, whose central banks intervene in the foreign exchange markets to fix the value of their currencies against the dollar.

This damages European exports to both the United States and Asia. Reduced European dependence on the U.S. export market can hardly protect Europe from the effects of the U.S. economic slowdown if the euro appreciates as much against the Asian currencies as against the dollar.

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The decoupling argument also assumes that recession in America has no effect on the Asians. This is nonsense. For example, China's commerce ministry recently warned that a slowing U.S. economy would trigger a drop in Chinese exports that would mark a turning point for China's rapid economic growth. Asian income certainly will slow if Asians export less to the United States—and this in turn will reduce Asian imports from Europe.

Thus, the U.S. slowdown affects European exports in two ways. It has an indirect effect on European exports to Asia, which can be sizeable because the U.S. market is so important for Asian exports. And it has a direct impact on European exports to the United States.

Even in the case where the direct effect is small—the decoupling assumption—the U.S. slowdown still can have a substantial net impact on European exports because of its indirect effect on Asian imports from Europe.

Europeans must resist the temptation to think they are somehow "decoupled" from American foibles and woes. Until recently, quite a few thought they were insulated from the current U.S. housing and mortgage crisis. How wrong they were.

In what has been a truly malignant "export" from America to Europe, the Americans created and packaged "garbage debt" from subprime mortgages, and the Europeans, hungry for extra yield and as reckless as the Americans, bought it. Many Europeans banks' balance sheets are now as contaminated as those of American banks, and no one is quite sure who is holding—or hiding—the junk, and how to value it.

This is why European banks are reluctant to lend to one another. They could be lending money to an institution in serious but yet undiscovered financial trouble.

It is hard to imagine that the higher market interest rates and reduced credit availability stemming from the credit crunch would not lead to distress for Europe's overall economy. Yet this is exactly the current stance of the European Central Bank, which is treating the Eurozone as if its financial sector was somehow "decoupled" from the rest of the economy—and running a different monetary policy for each sector at the same time.

By pumping in whatever liquidity the financial sector needs to alleviate the credit crunch, the European Central Bank, in effect, has a deflationary bias for the financial sector, whereas it has announced an inflationary bias for the rest of the economy.

A monetary policy at war with itself cannot long endure. The guess is that the European Central Bank's inflationary bias soon will be dropped, as the effect of the financial crisis and the U.S. slowdown sends Europe's economy into a spin that even the ever-optimistic European Central Bank will not be able to deny. The slowing European economy should moderate Europe's inflation concerns.

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Decoupling arguments, whether applied to relations between Europe and America or Europe's financial sector and the rest of the economy, have a single purpose—to deny the very real threats that presently exist to the continued expansion of the European economy. Some of this, no doubt, is wishful thinking on the part of economically unsophisticated people. Others have a special interest.

Good news sells better than bad. It makes it easier for the ECB hawks to sell rate hikes. It makes it easier for EU politicians to sell their policies, themselves, and their parties. And it makes it easier for investment houses to keep a bid under European stock markets.

Ordinary Europeans should not be fooled by the flim-flam. The very existence of decoupling arguments is a warning they should be concerned about the continuing robustness of Europe's economy. After all, would special interests be peddling such dubious pablum if they felt confident about the economy's future? ◆