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The disconnect behind Europe's financial free fall

By David Ignatius
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A month ago, many Americans were undoubtedly wondering why they should care about the debt burdens of faraway European nations such as Greece, Spain and Portugal. Now, with U.S. financial markets joining the rest of the world in getting pounded, we have our answer.

It's always a bit of a mystery why fear turns into panic, or why the galloping of a few horses produces a stampede. Europeans and Asians must have asked similar questions about cause and effect two years ago, as they watched a relatively small category of U.S. lending -- subprime mortgage loans -- produce a hysterical bank run on Wall Street that sucked liquidity out of the global financial system.

Once again, investors seem to be experiencing a financial version of vertigo: They don't know where the bottom is; they aren't sure what's solid and what may collapse; absent reliable information, they assume the worst; they get nervous about any piece of bad news and the contagion spreads.

The panic this week focuses on European economies and the banks that hold their debt. The situation isn't really any worse today than it was a month ago; arguably, in fact, it's a lot better, because the debt problems of the European weaklings have been identified and are being corrected. But the problem has become viral; it has spread from specific concerns to generalized fear. Add an extra jolt of anxiety about war on the Korean Peninsula and you had investors around the world running pell-mell for the exits.

In a conversation this week with Italian President Giorgio Napolitano, I had a chance to step back from this dizzying brink and hear a sober account of the European crisis. Napolitano is one of the grand old men of Europe, and for decades he has been a champion of European unity. But he conceded there's a radical mismatch between the ideal of economic integration and the reality that the eurozone has 16 different fiscal regimes -- a disconnect that helped produce this crisis.

"We have had a clear demonstration of the severe effect of a lack of consolidated policies," Napolitano said. With this crisis, he argued, Europeans must finally accept that union "implies a partial transfer of national sovereignty." The current halfway integration simply isn't strong enough to support a common currency, he suggested.

When a panic starts, each rescue measure seems to inspire new skepticism that the crisis can be contained. That's been the problem this week: The Spanish central bank took over a major lender, and four weak banks announced a merger; these moves were supposed to shore up confidence, but instead they triggered a wave of bank-stock sales across the continent.

Italy is trying to stanch the bleeding with a $30 billion budget cut that would bring its budget deficit below 3 percent of GDP by 2012. We'll see if investors find that promise credible.

Investors keep pounding Europe in part because they don't yet see the mechanisms that will enforce discipline. The European Union just established a trillion-dollar bailout fund, but what happens when it runs out? There's a pledge to impose strict conditions on Greece, Portugal and the rest in exchange for loans, but it still isn't clear how Brussels will make this austerity regime work.

The problem is the one Napolitano describes: Europe remains a union of convenience, which can be discarded by national governments when it suits their purpose. Northern European nations such as Germany like to chide their spendthrift southern counterparts for lack of discipline. But it was Germany and France that demonstrated the toothlessness of the eurozone's enforcement mechanisms in 2005 by refusing to pay fines when their budget deficits exceeded the limits of the E.U. Stability and Growth Pact.

What worries me is that the dictates of economics and politics are now in conflict in Europe. To sustain its common currency, Europe needs integrated fiscal policies that are enforceable on all members. But in this crisis, frightened publics are likely to cling all the harder to the tokens of national sovereignty -- and resist dictates from E.U. bureaucrats and central bankers. That's why Euro-pessimists think this crisis still has a ways to run: The doctor in Brussels may know what's needed, but the 16 patients haven't yet agreed to swallow the medicine. And the whole world feels the pain.