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# Why Europe has caught a cold

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'Whenever the US sneezes, Europe catches a cold'. Once more the old economists' saying appears to have been proved right. The IMF and the European Commission have successively dropped their forecast for European growth for 2008 by half a point. It seems so normal that no one has batted an eyelid. The same thing happens about every ten years. Last time the US economy took a dive in 2001 Europe suffered two years of stagnation and only really regained its strength in 2006.

This link may look like cause and effect but is not self-evident. First, Europe does not box at a lower weight than the US. With between 20% and 30% each of global production, depending on the way one measures it, the US and the EU are the world's two elephants, far bigger than Japan or China. The economy of EU27 even weighs in slightly higher than that of the US (the euro area's economy little lower). Europe can also claim equality by virtue of its volume of trade and the size of its financial markets.

What is more, Europe exports very little to the US. Only three times more than to Switzerland, barely 3% of its GDP. So any drop-off in trade with the US would cause only a minor tremor, especially as exports to China, Russia, Turkey and India have in recent years been growing at a rate of 15% per year. By comparison, Asia is much more dependent on US growth because of the volume and pattern of its exports. But the IMF has hardly tweaked its growth forecasts for that region.

In finance terms, interdependence has increased considerably since the middle of the 1990s. US assets in the euro area represent close to a quarter of the zone's GDP, five times more than ten years ago. When Wall St rises or falls, Europeans feel it in their pocket. But Wall St has not in fact fallen much in the last year, a lot less than European stock exchanges – 5% in the case of the Dow Jones, against 15% for the CAC40. If the US financial market has had any influence, it has rather been as a shock absorber.

Then there is the subprime issue. At the start of the decade Europe suffered from the volume of losses incurred on the other side of the pond by businesses and investors who had bought technology stocks too late and too dear. This time we can only guess at the scale of the losses caused by the rout in the subprime real estate derivatives market. Of the 400 billion potential loss which the G7 mooted at the beginning of February, about one half will be located in the US where banks have already announced more than 80 million in losses, the other half in the rest of the world, chiefly in the EU and Switzerland. This once again confirms the astonishing capacity of Europeans to make high-risk investments. Let us suppose, on a pessimistic hypothesis, that losses do prove to total 400m USD, and that EU27 banks end up carrying one third. That would represent a shock of about two thirds of a point of GDP, manageable in macroeconomic terms but destabilising for some banks, and material for the banking system as a whole.

The list is long of the channels by which the US crisis has been transmitted to Europe (contagion between real estate markets, increasing aversion to risk) and it would be possible to assess the relative weight of each. Or one might scan the possible good news and assess the effects of a US slow-down on oil and commodity prices. One could seek to evaluate the response of exchange rates to economic policies and their impact on European growth.

But this would perhaps miss the key point. Beyond the analysis the pessimism of forecasters about Europe is arguably to a greater extent attributable to the belief that, in a situation of turmoil, Europe will be incapable of finding the wellspring of its own growth. The OECD recently popularised the notion of ‘resilience’ to denote the ability to bounce back after a shock. This is exactly the quality which European economies lack. They give the impression that they can only thrive in good times and may stumble at any moment.

A huge and sophisticated economy, which could be a global, or at least a regional, growth engine, is perceived – and often acts – like a fragile and second-order one. This self-styled dependence probably stems to a great extent from the doubts that Europeans themselves have about their ability to take their economic destiny into their own hands, about prospects for a decent return on investment, and about the quality of their own economic policies. In a nutshell, what Keynes dubbed the ‘animal spirits’ of capitalism. At the end of the day, economic Europe is indeed an elephant but one suspects that it may have the brain of an ostrich. Let us hope that the next few months belie this dismal impression.