The Economist

Charlemagne

Still sickly

The euro zone's illness is returning. A cure requires more integration, but Germany isn't keen

Mar 31st 2012 | from the print edition

WHEN the editors of the German tabloid *Bild* met Mario Draghi recently they gave him a *Pickelhaube*—a spiked helmet—to remind the Italian that they had last year depicted him in Prussian garb as the most Germanic of candidates to run the European Central Bank. It may come in useful: hardliners are taking shots at Mr Draghi for spraying banks with €1 trillion ($1.3 trillion) of cheap money. This "powerful drug" may have side-effects, he

says, but it works: “The worst is over” for the euro zone.

Don’t be so sure. The fever has been rising again in Spain after the government wildly overshot its deficit target last year. The Italian prime minister, Mario Monti, expressed alarm (which he later withdrew) that the Spanish illness might harm his own country’s convalescence. Portugal and Ireland are in recession, and may need second bail-outs; Greece will probably require a third rescue (and the restructuring of official debt).

As fear returns, so have calls to boost the euro zone’s rescue funds. “The mother of all firewalls should be in place, strong enough, broad enough, deep enough, tall enough—just big,” says Ángel Gurría, secretary-general of the OECD, the rich-world think-tank. But Germany prefers a slow, incremental response. The latest signal is that it will agree, at a meeting of finance ministers in Copenhagen on March 30th and 31st, to raise the firewall somewhat. The temporary rescue fund, the European Financial Stability Facility (EFSF), would be allowed to overlap with the permanent new European Stability Mechanism (ESM), which is to be activated this summer. By combining the two funds, perhaps only for a year, the lending capacity could be raised from €500 billion to about €740 billion.

This may be enough to persuade the Chinese, the Americans and others to allow the IMF to increase its resources, so helping the defences, but it is hardly the overwhelming force Mr Gurría seeks. Germany worries that reducing the pressure on weak states will lead to complacency. “The Germans think that the only way to make countries reform is to dangle them out of the window,” says one diplomat. “This only reinforces the belief in the markets that the euro zone is on the edge of disaster.”

One worrying sign for Germany was Spain’s partly successful attempt to loosen its deficit target this year. Another is growing trouble over the “fiscal compact”, a treaty signed by 25 European Union countries to toughen budget discipline. Ireland, with a history of awkward votes on EU treaties, holds a referendum on May 31st. The Socialist front-runner

in the French presidential election, François Hollande, wants to renegotiate the deal to include more focus on growth. Germany's opposition Social Democrats are making similar noises. In the Netherlands the opposition Labour Party—which is supposed to support the minority government on European issues—threatens to block ratification if the government imposes austerity to meet next year's deficit target of 3% of GDP. (Ill-disciplined countries that have received a tongue-lashing from the Dutch are savouring the irony.)

Even assuming all these difficulties are resolved, the fate of the euro will remain uncertain. Raising the firewall and ratifying the compact will address only some of the symptoms. A cure requires "treating the whole patient", as set out recently in a clear-eyed paper by Jay Shambaugh for Brookings, an American think-tank. It says the euro zone is afflicted by three ills: a banking crisis, a sovereign-debt crisis and a growth crisis. Dealing with one often makes the others worse.

A big problem is that the euro zone is only partly integrated. Its members have given up economic tools, such as currency devaluation and monetary policy, yet lack "federal" instruments to cope with shocks. The problem is not so much the budget deficit (though Greece was certainly profligate) as the net foreign borrowing by all actors, public and private (say to finance a trade deficit). The euro zone has only small internal transfers, and its workers tend not to move far for work. Fiscal stimulus is impossible for most governments, given their indebtedness. Structural reforms to promote growth can take years to work.

So redressing the imbalances must come through "internal devaluation": bringing down real wages and prices relative to competitors. This was easier before 1991, when inflation around the world was higher, but has rarely been achieved since then (Hong Kong is one exception). With the ECB determined to keep inflation at around 2%, internal devaluation brings severe recession, even depression. And falling GDP wrecks the debt ratio.

Mr Shambaugh offers some advice. Deficit countries could cut payroll taxes to reduce labour costs and raise VAT to discourage imports; the effect would be magnified if surplus states did the opposite. Germany could help by stimulating its economy, or at least slowing down its budget consolidation. The ECB could let inflation run higher, especially in Germany, and could declare that it stands fully behind solvent sovereigns. The EFSF/ESM could recapitalise weak banks. A Europe-wide bank-deposit insurance scheme would help. Mutualising part of the national debts would create a risk-free European asset.

The German problem (again)

All these options ultimately run into the same obstacle: Germany. It does not want to bear bigger liabilities, it wants to set an example of budget discipline, it refuses to compromise its competitiveness, it is allergic to inflation, it does not want the ECB to print money and it thinks Eurobonds create moral hazard.

There is little sign that the chancellor, Angela Merkel, is ready to do much beyond tweaking the firewall and pushing through the fiscal compact. She talks of a future “political union”. If she really wants to save the euro, she will have to put on a *Pick elhaube* and lead the way to greater fiscal federalism.

Economist.com/blogs/charlemagne (http://www.economist.com/blogs/charlemagne)

from the print edition | Europe

Copyright © The Economist Newspaper Limited 2012. All rights reserved.

Legal disclaimer Accessibility Privacy policy Terms of use Help