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The laws of euro-nomics

German legalism is hampering rational crisis-management

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SOME say economics in Germany is treated as a branch of moral philosophy. More often it is the worst sort of contract law. Throughout the euro crisis legal pettifogging has hampered rational policy. The German finance ministry is filled with lawyers, not economists, starting with its boss, Wolfgang Schäuble. Big decisions have often ended up at the constitutional court in Karlsruhe. The euro zone wasted time tightening fiscal rules that treated mostly symptoms (budget deficits) not causes (a deficient structure and crippled banks) and led to excessive austerity. The European Central Bank's action that saved the euro in 2012 has recently been undermined by the Karlsruhe court, which thinks that the never-used "outright monetary transactions" (OMT) programme to buy bonds of countries that agree to reforms is illegal. And now excessive legalism has messed up the banking union, which will not live up to the promise to sever the doom-loop between weak banks and weak governments.

Having survived and returned to weak growth, the euro zone faces a new danger: deflation. But lawyerly nitpicking is again one factor holding up an effective response. Deflation raises the burden of debt and causes consumers to stop spending, because they expect cheaper prices. Low inflation makes it harder to adjust wages and prices relative to Germany. Headline inflation has dropped to an annual 0.5%, far below the ECB's target of "below, but close to, 2%". Some countries are already in deflation; any new shock might push the euro into yet another crisis.

Ensuring price stability is the core business of the ECB. Even the ultra-conservative Bundesbank in Germany, which opposes the ECB's bond-buying, agrees it must act against deflation or even persistently low inflation. The Bundesbank's head, Jens Weidmann, says he will consider entering the "uncharted waters" of QE (quantitative easing, in which central banks print money to buy assets and thus bring down long-term interest rates) already pursued in America, Britain and Japan.

German legalism is also affecting the ECB. Its president, Mario Draghi, who in July 2012 promised to do "whatever it takes" to save the euro, now seems to be doing whatever it takes to avoid a hard decision. He tries to talk down interest rates through "forward guidance", and speaks of the ECB's unanimous readiness to consider unconventional measures. To Philippe Legrain, a former adviser to the European Commission and author of a new book on the crisis (and once a journalist on *The Economist*), the ECB has a deflationary bias: contrast its inaction over falling prices with its hair-trigger response to the illusory danger of inflation in 2011, when it raised interest rates at the height of the crisis.

But that deflationary bias also in part stems from Germany's influence—and inevitably that of the court in Karlsruhe. Many expect Mr Weidmann's agreement in principle to OMT and to the idea of bond buying to turn to disagreement over specific measures. Karlsruhe's hostility to OMT casts a pall over quantitative easing. The judges made much of the distinction between monetary policy carried out by ECB technocrats and economic policy that needed greater political legitimacy. The court said buying the bonds of some countries to lower borrowing costs discriminates against others, impairs the market mechanism, increases the risk of losses for the ECB and violates the prohibition on monetary financing of states. Yet almost any act of monetary policy is a form of redistribution between savers and borrowers.

Mr Weidmann hints he would rather buy private debt than government bonds. A rival school of thought holds that, in fact, buying private debt resembles industrial policy, in that it might favour some sectors over others. In any case, there might not be enough corporate debt to buy, since most euro-zone companies are financed by banks. So, beyond another small cut in interest rates (which are already close to zero), or the imposition of negative deposit rates, the ECB might end up buying sovereign bonds after all.

One worry is that QE might not make much difference, doing too little to raise inflation and failing to stimulate more lending. Ideally, the euro zone should first fix the banks. That might happen at the end of the year, when the ECB completes its review of bank balance-sheets before taking over as the euro zone's lead bank supervisor. But new rules to impose losses on creditors will not come fully into force until 2016. The single resolution mechanism to wind down banks is too legally convoluted and lacks a credible taxpayer-financed backstop. Given the "bogus" banking union, as Mr Legrain calls it, the ECB might prefer to hide problems rather than to reveal losses that countries are unable or unwilling to bear.

Argentina—or Japan?

German legalism is a sign of a deeper disagreement: governments want the convenience of a single currency, but not the risk-sharing and transfers of a federation. Germany rejects liability for others. It has blocked Eurobonds and a common backstop for banks. It has bailed out troubled countries through loans, but only on strict conditions. It has tightened fiscal rules and persisted in running large surpluses, worsening deflation and creating political resistance, most recently in France and Italy. And when German ministers have turned a blind eye, the Bundesbank and Karlsruhe have tried to limit risk-sharing through the ECB.

The defence of the national treasury provides exciting work for lawyers, but it makes for poor crisis-management. To work properly, a currency union needs some degree of fiscal union. Until the ECB stepped in as a lender of last resort in 2012, euro-zone countries were in effect so many Argentinas, all borrowing in a foreign currency. But unless it acts quickly to avert deflation, they could yet become latter-day Japans.

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