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The political constraints of the eurozone

di Wolfgang Münchau

First steps are always the most difficult. Last week's declaration by the European Council in favour of a Greek bail-out may not have gone as far as some people had wished. It did not even go as far as the draft declaration agreed the night before. But it was an event of historic significance nonetheless. The European Union has acknowledged, for the first time, that the eurozone has a political dimension, and is willing to defend itself against speculative attack. At the same time, the EU will attach strong conditionality to any aid. The angry reaction of the Greek prime minister is the best indication that we should not worry too much about moral hazard. Whether eurozone member states will buy Greek bonds outright, or merely guarantee them, is an important technical issue, but the most difficult part was last week's political agreement.

I expect that the guarantee will end this acute phase of the Greek crisis, provided the Greek government does not renege on its promises. It might also reduce the pressure on default insurance premiums for other eurozone countries. The technical details of the final package will include some harsh conditionality to avoid moral hazard. It will be both generous and mean. But as important as this decision was, it will not solve the problems of the eurozone on its own.

Consider, for a minute, the German position in all of this. The German media's reaction to this bail-out was bordering on the hysteric. There are big differences of views even inside Chancellor Angela Merkel's own party. She is also constrained by the 1993 Maastricht treaty ruling of the German constitutional court – which as I understand was an important consideration in determining her stance last Thursday. The court stipulated that stability is an unalienable basis for Germany's participation in a monetary union. Should this principle be violated, the legal basis for Germany's participation would no longer be valid. Article 125 of the Lisbon treaty – the infamous "No Bail-out Clause" – is legally an important aspect of the overall stability of the system. And some people will no doubt argue that a Greek bail-out would violate article 125.

Last year's German constitutional court ruling on the Lisbon treaty added further impediments to effective eurozone economic governance. The court stated unambiguously that macroeconomic policy must remain the competence of the member states. Of course, justices are never objective interpreters of the law, and are always influenced by current political fads. Nor do all German lawyers agree with the constitutional court. But the ruling stands for now. We should be under no illusion about Germany's political and legal room for manoeuvre. Germany is prepared to show solidarity to weaker members of the eurozone if they are subject to a speculative attack. That was a huge step for them. Do not expect a lot more.

The surreal discussion about the eurozone's future tends to ignore the legal and political constraints. Consider one argument that central banks, not just the European Central Bank, should consider raising inflation targets from about 2 per cent. There is no danger that the ECB would adopt this proposal. If it did, the German constitutional court would be guaranteed to invoke its 1993 ruling. More importantly, I would expect German public opinion, having swallowed the toad of a Greek bail-out, would drive Germany out of the eurozone.

So discussion about the future of the eurozone should take account of the political and legal constraints. A fiscal union is not going to happen. Nor will the EU embark on yet another treaty change.

What can be done under the existing framework? The first priority is to address the internal imbalances. Spain and Greece suffered a significant loss of competitiveness against Germany, which needs to be partially reversed this decade. Even now, the gap in real wage costs continues to widen. For this, you need a policy co-ordination mechanism that involves political leaders, not just finance ministers. While Spain, Portugal, Greece and Italy should reform their labour markets, Germany should be encouraged – within the limits set by the constitution – to raise domestic demand. Last year's constitutional balanced budget amendment was unhelpful in this respect. Over the next two years, the promised income tax reform is probably the best hope.

The second priority is fiscal consolidation. It is fanciful to think economic growth alone can take care of the debt. Growth rates in this decade are likely to be even lower than in the last. In almost all eurozone countries, consolidation is best accomplished through expenditure cuts, not tax increases.

The reduction of imbalances and public sector debt must have priority this decade. It will require very tough choices from political leaders who ran away from those choices in the last decade. Last Thursday's declaration was a big step in the right direction. But the worst that could happen now is a leap into the imaginary world of soft options. That would be the end of the eurozone.