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The last chance to rescue the euro

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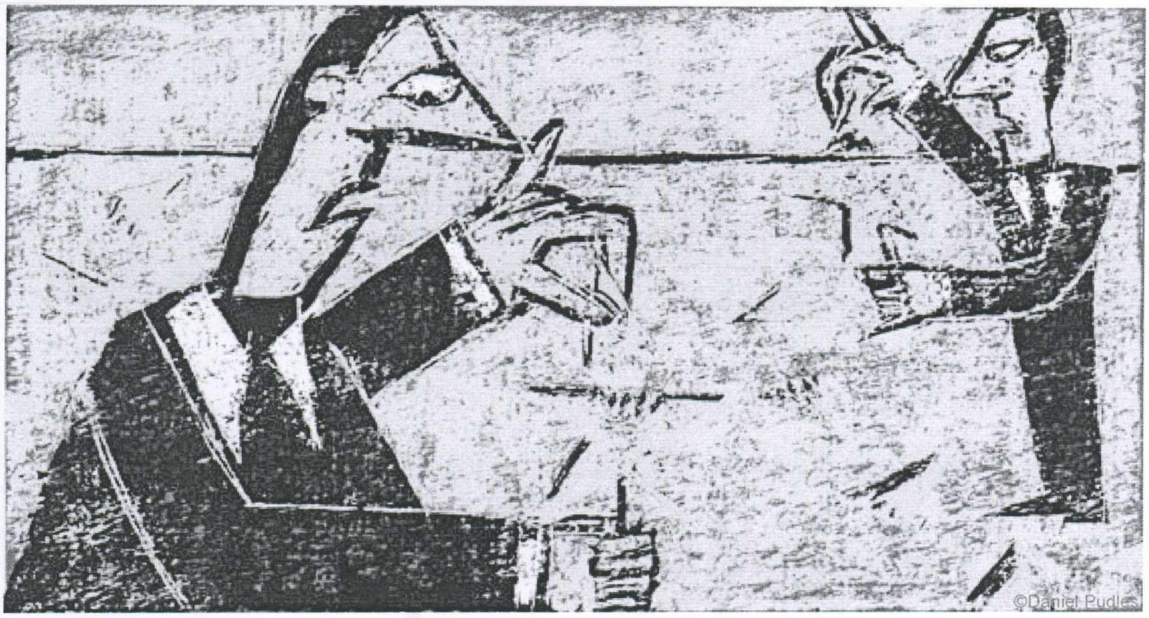

Europe's leaders should step out of the playground. The euro debate has become an infantile shouting match about a series of specious choices: fiscal austerity versus growth; spending cuts against jobs; market reforms or social inclusion. This way lies madness – and the certain disintegration of the single currency.

The clock is now showing one minute to midnight. Greece is probably beyond saving. The early signs of bank runs in Spain and other peripheral economies suggest the virus of contagion is taking hold even before Athens makes up its mind in a second general election. Policy makers have less time than they thought only a few days ago.

François Hollande's election in France has been widely seen as a threat to the coherence of the eurozone. To the contrary, the rebalancing of the relationship between Berlin and Paris should be viewed as a last chance for a grown-up conversation. With or without Greece, the eurozone needs a new strategy – a grand bargain, if you like. The vital ingredients are clarity and credibility.

In pursuit of clarity governments should start by publicly agreeing on what they can agree on. Everyone presumably can sign up to the idea that deficits and debts must be brought down to sustainable levels. All should be able to admit that restoring competitiveness in the peripheral economies will require wrenching structural reforms. It is also self-evident that, without economic growth, debts and deficits will remain high and political consent will evaporate. You do not have to be a Keynesian to recognise debt traps. Finally, improvement in the trade positions of eurozone weaklings requires smaller surpluses in the strong economies.

Germany's Angela Merkel is right when she says Europe's nations cannot borrow their way out of trouble. Mr Hollande cannot be gains-aid when he says growth is essential to restore fiscal sustainability. Mario Monti, the other member of the pivotal troika of European leaders, is on track when he says that there must be a pan-European dimension both to growth-stimulating investment and to market-based structural reforms. Germany could start by opening its services sector to continent-wide competition.

Politicians have to face up to one other simple truth. For a couple of centuries, Europe set the terms of its engagement with most of the rest of the world. Its economic and social structures were framed accordingly. The rise of the rest has upended this assumption. This need not mean scrapping the European social model. But it does demand a radical redesign.

The central point – blindingly obvious but lost to the cacophony – is that what matters is the mix and sequencing of policy choices. Deficit-reduction depends on growth, but growth is sustainable only in the context of preprogrammed fiscal discipline. Thinking in terms of binary choices is self-defeating: when the discussion turns to Keynes versus Hayek, the game is lost.

So how to get the policy mix right? This is where credibility comes in. The beginning of wisdom here is to recognise that credibility is a moving target. A year or two ago, all seemed straightforward: the financial crash had left huge government debts and deficits and created a lethal feedback loop between the solvency of the banks and the creditworthiness of sovereign borrowers. The only way to restore confidence was by slashing public spending, raising taxes and bringing down deficits.

So it seemed. It is worth saying this was not some German plot to seize control of the eurozone. Sitting outside the single currency, Britain had no need to take lectures from Berlin. Yet the first decision taken by David Cameron's coalition was to accelerate plans to eliminate Britain's structural deficit. Without such a pledge, it declared, credibility would evaporate and interest rates would soar. As I recall, the approach was applauded by the Organisation for Economic Co-operation and Development and the International Monetary Fund.

This week saw confirmation that much of the eurozone is mired in recession. Britain is in the same boat. Spending cuts and tax increases have not brought the expected falls in deficits. As a result, the markets have been having second thoughts about what constitutes a credible strategy. So, too, incidentally have the experts at the IMF and OECD. Even in Berlin there has been a subtle change of tone. Inexplicably, Mr Cameron alone seems determined to nail himself to the cross of austerity-come-what-may.

The implosion of the mainstream parties in Greece has added political risk to the confidence equation. Fiscal retrenchment can be credible only if it retains the consent of electorates. In the absence of economic growth, how long will Spanish, Portuguese, Irish and Italian voters bear the fiscal pain? Austerity policies designed to sustain credibility have now begun to have precisely the opposite effect.

There will be nothing easy about finding a mix that will reclaim the confidence of investors. European leaders would make it less hard by offering some counter-intuitive policy commitments. Mr Hollande could say that efforts to underpin the European economy will be accompanied in France by serious structural reform. Ms Merkel could promise that ironclad commitments to fiscal discipline will be accompanied by German leadership in promoting growth.

That would still leave plenty of arguments to be had: about the size and scope of firewalls, the expanded role of the European Central Bank, the shape of fiscal union, debt mutualisation and the rest. But what is needed first is a clarity that begets credibility. Without these ingredients, all the rest is academic.

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