Peter Holmes contribution to this edition of Euroscope has outlined the key challenges which Eurozone Governments and institutions are facing.

These challenges are real; however the Eurozone as a whole has a current account surplus, a low government deficit, and a relatively modest overall debt position. When the Eurozone asks the rest of the world to help finance the vehicles created to resolve European debt, it is then not surprising that they reply ‘what problem’ or ‘why don’t you sort out your local difficulties yourselves’.

The problem of course is that the 17 member states are sovereign countries with independent fiscal policies, not regions of one centrally controlled state. In addition the member states’ citizens do not recognise the European institutions as the centre of their democratic life but rather their national parliaments. And national governments have to be elected (and reelected) by national electorates.

As Peter explains, by creating the impression that constituent governments and their citizens could borrow at interest rates equivalent to those in Germany, the monetary union meant that governments could borrow beyond reasonable levels, real estate bubbles could get out of control, and difficult structural reforms could be put off for a later government to tackle. The fact that Germany itself sinned once before in weakening the rules of the Stability and Growth Pact reinforces Germany’s determination to ensure the rules of an ever stronger stability mechanism in the Eurozone are enforced. Germany has confessed and repented; it is now time for today’s sinners to repent.

The fact that several of the countries, which find it difficult or impossible to raise funds on international capital markets, also occupy the lower ranks of tables on progress with structural reform and perform very badly in Transparency International’s Corruption Perceptions Index underlines the institutional and political weaknesses in these countries. Institutional problems are extremely hard to resolve and, short of a revolution, resolution generally takes a long time. It is these doubts about the capacity of some Eurozone states to run sensible (German) fiscal and structural policies, which prevent Germany at present from supporting the most straightforward solution to the Eurocrisis – allowing the ECB to perform the function of lender of last resort.

Allowing the ECB to buy unlimited amounts of bonds from indebted Eurozone governments would probably be less of a potential burden on German taxpayers than the cost of recapitalising German banks if Greece and Italy need to reschedule their sovereign debt. It would however take the pressure off these countries to reform, run responsible fiscal policies and avoid speculative bubbles in key markets. The risk that, in that case, Mario Monti would be cast aside and replaced by Berlusconi would be significant and Germany might be faced with the creation of a ‘Transferunion’ which it fears above everything else.

This also partly explains why the policy response of the Eurozone Governments has been so slow and hesitant. They have always been dealing with yesterday’s problem when the crisis has moved on. Early action to stem contagion taken in 2010 might have avoided Italy and Spain being condemned
to paying very high interest rates to fund their debts and facing apparently insurmountable financing challenges. But Chancellor Merkel’s policy of taking small steps and resisting pressures from junior partners like France for a quick fix has played well with domestic voters.

The German Chancellor faces considerable domestic pressure. Two German Social Democrat MPs have filed a suit to the Constitutional Court arguing that the whole Bundestag should be involved in the approval of bailouts by the EFSF. The CDU-CSU/FDP coalition looks increasingly divided over the issues of bailouts and reforms, and the FDP called a vote by its members whether to support the European Stability Mechanism or not by mid-December 2011.

Merkel has kept the pressure up on wayward southern states in the Eurozone to continue the reform process. It is almost certain that the German government does not want the monetary union to fail and it knows full well that eventually it is going to have to go for a solution which allows the southern European states to meet their obligations. However before it takes that step, it must be sure, as far as is possible, that the dramatic problems faced by the Eurozone do not recur in the future. Hence its insistence on Treaty changes and the move towards a ‘fiscal union’.

Although Germany certainly does not want a position as Europe’s ‘hegemon’ (whatever that means), gradually EU members are coming round to asking Germany to fill that role, albeit only as saviour of the Euro. It was remarkable that even the Polish Foreign Minister, Radek Sikorski, pleaded with Germany to play this role to save the Euro and the European Union in a speech in Berlin on November 28. 2011: ‘you (Germany) have become Europe’s indispensable nation and I fear German power less than I am beginning to fear German inactivity’.

As Jim Rollo writes, the European Council meeting on December 9th 2011 underlined general support for the German position, although the United Kingdom chose not to participate even in the negotiation of a new ‘stability’ treaty, which will now be negotiated outside the EU Treaties. The 23 or 26 member states which may eventually agree and ratify the new inter-governmental treaty in March 2012 will be agreeing to implement quite severe disciplines in fiscal policy. The markets appear to think that it will be extremely difficult to get agreement on this new treaty, involving as it does parliamentary decisions in most countries and perhaps ratification in a few.

Of course there are major risks in this policy, even if the new treaty is agreed. A strict German-style stability policy will make it harder for the peripheral countries to return to growth. As Peter writes, small Ireland can do it by cutting unit labour costs and expanding net exports but large Italy and Spain can’t do it. Both have major competitiveness problems even if insolvency can be avoided and liquidity improved. Can the democracies of these countries survive a decade of real wage decreases, slow growth and high unemployment? Germany can do it (real wages in Germany between 2000 and 2010 fell by over 4%) but can Italy or Spain?

However a more imminent risk is that Italy finds it impossible to raise finance to meet its obligations in early 2012 and we are faced with a disorderly break-up of the Eurozone with extremely high costs to banks and individuals in all EU-27 member states.

Most people understand Frau Merkel’s predicament as well as the need for fundamental corrections to the Eurozone-system to ensure stability and growth in the medium- and longer term. But in the short-term we may be dead!!