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A disastrous failure at the summit

By Martin Wolf

Whom the gods wish to destroy they first make mad. That was my reaction to the outcome of last week's meeting of the European Union's Council. Many focused their attention, understandably, on the decision by David Cameron, UK prime minister, to veto a new treaty. But the UK's behaviour took attention away from the failure of the eurozone's leaders to devise a credible remedy for the ills of the currency union. They propose, instead, to tighten the screws on fiscal deviants. It may feel good. But it will not work.

Mr Cameron presented his colleagues with a list of demands designed to protect both the City and the ability of the UK government to regulate it, largely unhindered by European regulators. Mr Cameron could have stated, instead, that he would accept a treaty applicable only to members and candidate members of the eurozone. He could have intimated that he would put a treaty that did any more than this to a UK referendum (which would have been surely lost). Instead, he ended up with no additional safeguards for the City and a semi-detached status inside the European Union, of which, he has insisted, he wants the UK to remain a member. That is not a success. He has achieved nothing positive, but will undermine the credibility of UK membership of the EU. That brings substantial costs.

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Yet far more important than this piece of British political theatre is what might now happen inside the eurozone. On this I am pessimistic. Germany and France have agreed that there is to be no fiscal, financial or political union. The failure to transcend the defects of the original construction is predictable, but dire.

The core decision was to strengthen fiscal discipline, so building what Angela Merkel, Germany's chancellor, and Nicolas Sarkozy, the French president, last week called a "stability and growth union" – or, as I think of it, an "instability and stagnation union". Even under an intergovernmental treaty, this reinforced discipline could probably still occur via EU institutions, as Olli Rehn, European commissioner for economic and monetary affairs, now argues.

What are the chief details? First, as the eurozone heads of government stated, "general government budget deficits shall be balanced or in surplus: this principle shall be deemed respected if, as a rule, the annual structural deficit does not exceed

0.5 per cent of nominal gross domestic product". Second, "such a rule will also be introduced in member states' ... legal systems ... The rule will contain an automatic correction mechanism that shall be triggered in the event of deviation."

A simple objection to these ideas might be that they are implausibly tough, as FT Alphaville notes. The Council does state that "steps and sanctions proposed or recommended by the Commission will be adopted unless a qualified majority of the euro area member states is opposed". Even so, I remain unconvinced that turkeys will vote for Christmas. Yet, suppose they do. This would mean that, on deeply uncertain estimates of structural deficits, the Commission – a body of unelected bureaucrats – would impose sanctions on elected governments, when the latter are under great pressure. What is the Commission going to do if they still fail to comply? Take them over? The answer, we now know, is: yes. This is a constitutional monstrosity.

Still more important, as professor Kevin O'Rourke of Oxford university argues on Project Syndicate, is that it is also an economic monstrosity. Let me make this point by turning last week's analysis of the balance of payments into one of foreign, private and government financial balances in eurozone members (see charts). To remind readers: these have to add up to zero, by definition. But how they go about adding up is revealing.

As I noted last week, fiscal imbalances were modest before the crisis, but the current account imbalances were huge. Surplus private funds in some countries (notably Germany and the Netherlands) were intermediated by the financial system to fund private deficits in others (notably Greece, Ireland, Portugal and Spain). When crisis hit, these flows ceased. Deficits of private sectors collapsed (most turning into surpluses), while fiscal deficits exploded. Now, says Germany, the latter must be slashed.

By definition, the sum of private and current account deficits must also fall towards zero. The private sectors of erstwhile capital-importing countries have moved towards surpluses, for a good reason: they are trying to reduce their debts, not least because their assets are falling in value. Thus the external deficit needs to fall. That can occur in a good or a bad way. The good way would be via increased output of exports and import substitutes; the bad would be via a deeper recession. The good way requires far higher imports in the core of the eurozone or far greater competitiveness for the eurozone as a whole. But little chance of either of these exists, under plausible expectations for demand and activity. That leaves the bad way: deep recessions, in which the government reduces its deficit by deflating the private sector yet more.

In brief, it is extremely difficult to eliminate fiscal deficits in the structural capital-importing countries, without prolonged recessions or huge improvements in their external competitiveness. But the latter is relative, so the needed improvements in the external performance of weak eurozone countries imply a deterioration in that of eurozone capital-exporters, or radically improved external performance for the eurozone as a whole. The former means that Germany becomes far less German. The latter implies that the eurozone becomes a mega-Germany. Who can believe either outcome is plausible?

This leaves much the most plausible outcome of the orgy of fiscal austerity: long-term structural recessions in vulnerable countries. To put it bluntly, the single currency will come to stand for wage falls, debt deflation and prolonged economic slumps. Can this stand, however big the costs of a break-up?

The eurozone has no credible plan to fix the flaws of the eurozone, apart from greater fiscal austerity: there is to be no fiscal, financial or political union; and there is to be no balanced mechanism for economic adjustment on both sides of the creditor-debtor divide. The decision is, instead, to try still harder with a stability and growth pact whose failures have been both predictable and persistent. Yes, Mr Cameron made a blunder last week. But that of the eurozone looks far bigger.