Killing the euro-patient?

The doctors think the medicine will work, if the euro does not die first

The European Commission this week released its health check of European economies—and the verdict at times seemed surreal. “I can say the medicine is beginning to work,” said José Manuel Barroso, the commission president. Forget alarms over Greece’s imminent departure and wild oscillations in Spanish bond spreads. The good news is that budget deficits are coming down and other imbalances are being redressed. So the doctors prescribe more of the same: austerity, structural reform and a war against tax evasion. But behind the impression of confidence, the commission is rethinking its treatment.
Super-fit Germany has made the adjustment earlier than planned and been released from the “excessive deficit procedure”. Bulgaria was similarly freed, proving that discipline is not just for the strong. They will join Estonia, Finland, Luxembourg and Sweden in the club complying with deficit targets. Hungary, which had incurred disapproval all round, now gets a nod for tackling its deficit: the commission recommended lifting a threat to withhold a chunk of aid.

Senior Eurocrats see this as evidence that the system of economic governance is working. Brussels monitors national budgets and economic policies under the so-called “European semester”, culminating with country-specific recommendations. They comprise some 1,500 pages of analysis, diagnosis and prescription for each of the European Union’s 27 members. If naming and shaming is not enough to push governments into reform, the commission has powers to recommend sanctions, enforceable unless a weighted majority of ministers blocks them.

Yet it is one thing for the commission to crack the whip on the smalls (earlier this year Belgium fell into line). But will big countries like France take orders from Brussels? The commission says France will miss its target of cutting the deficit below 3% of GDP next year, and it should “accelerate” deficit-reduction measures. In effect, François Hollande, elected on a pledge to turn Europe away from austerity, is being told by Europe that he needs more austerity—and fast.

Many recommendations for structural reform and liberalisation will scarcely be more palatable to Mr Hollande. France was one of 12 countries subjected to in-depth studies this year. It was found to face “serious imbalances”, particularly declining competitiveness and falling share of exports. As with deficits, failure to redress excessive imbalances is subject to punishment. ”You have to be a repeat sinner,” explains a senior Eurocrat. “But if countries use the recommendations as toilet paper, then we would be justified in recommending sanctions.”

Many countries in Europe, especially in the south, need deep and prolonged structural reforms to enhance their growth potential. Yet the commission's recommendations are a bit like prescribing chemotherapy for a tumour while ignoring signs of imminent heart failure. Greece is in depression, and its second election next month may push it out of the euro, with unpredictable consequences. Separately, the weight of bad loans in Spanish banks is close to crushing the fourth-largest economy in the euro zone. So beyond the little tonics of short-term measures to boost "investment" that are likely to be approved at a summit next month, the commission knows that more needs to be done.

For the past two years it has told countries, particularly troubled ones, that sticking to deficit targets would be the best way to regain credibility in the markets. Now it is telling Spain not to overdo it. Trying to meet the 3% deficit target next year, from 9% in 2011, is too rapid an adjustment. In its enfeebled state, Eurocrats now concede, more harsh deficit-cutting may cause a dangerously severe recession. So the commission says Madrid can have a year longer, reaching the target only in 2014. The condition is that Spain should sort out its banks, draw up a credible budget to 2014 and, above all, impose the same discipline on its regions.

Another sign of change is that the commission has issued recommendations for a 28th "country": the euro zone as a whole. It says most adjustment must fall on deficit countries, but surplus ones "can contribute". It would be too much to expect the commission to urge the Germans to stimulate their economy and let inflation go. But it hints that they could remove "unnecessary regulatory and other constraints on domestic demand".

The real cure

The biggest spur to growth would be to remove uncertainties about the euro's survival. The election of Mr Hollande has freed Brussels to talk more openly about future steps, such as progress towards a "banking union" at European level and a "fiscal union" (including joint issuance of debt). Mr Barroso says that although these may take time, starting them would help restore confidence in "the solidity and irreversibility" of the single currency.

Yet there are two problems. The first is that Greece (or Spain) could blow up long before then. Spain may very soon need European cash for its banks to avoid loading up more public debt. The second is that "more Europe" runs into severe political problems. Germany is reluctant to stake more money to help weaker members of the euro ahead of its federal election next year. And more widely, citizens across the EU are increasingly disenchanted with the whole European project.

An opinion survey by the Pew Research Centre this week finds a majority in most of the eight countries surveyed thinking that EU integration has weakened national economies. In many places only a minority agree that EU membership is a "good thing". In France, Italy and Spain a plurality thinks the euro is now a "bad thing". That said, in all countries a majority favours keeping it. But this is a worryingly flimsy base on which to build a bigger economic and monetary union.

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