Euro wobbles

Portugal's constitutional court creates new problems for the euro

A New month, a new crisis. In February Italy's voters rebelled against their political class and European austerity. In March Cypriot depositors took to the streets to denounce an ill-conceived plan to tax all bank savings. Now Portugal's judges have struck down key parts of the government's austerity programme as anti-constitutional.

The court ruling turned Portugal from a quiet but promising student in the euro's remedial class into yet another troublemaker. In Brussels officials barely disguise their contempt for the black-robed judges who have decided that cutting the 14th month of pay for public-sector workers and pensioners constituted unfair discrimination. "It's the last socialist constitution in Europe," grumbled one Eurocrat. For Portugal, the ruling endangers the promise of an extension of maturities on its euro-zone loans and reduces the chances of graduating from its bail-out programme on time next year. Moreover, the upheaval raises questions for the euro zone. If one of the best pupils is failing, what does it say about the policy of austerity it is imposing? Even if it is justified, it may not be working fast enough to stop political erosion in debtor countries.

That Portugal has managed to stay out of sight for most of the time since it was bailed out in 2011 is an achievement in itself. Its sins were perhaps the least distasteful to creditors. Portugal broke fiscal rules like many others. But it was not mendacious and profligate like Greece; it did not recklessly run a low-tax economic model off the rails like Ireland; it has not lived off dodgy Russian money like Cyprus; and it did not permit a runaway property boom like Spain. Instead Portugal was a chronic underachiever, suffering from years of low growth. It was a bit like Italy, minus the self-indulgent public debt and bunga-bunga parties.

And since its rescue, Portugal has been most devout in repentance. Both the ruling centre-right party (confusingly called the Social Democrats) and the opposition Socialists embraced salvation through austerity and structural reforms. Unit labour costs have fallen, exports are rising (Portugal is enjoying its first trade surplus in decades) and the current account is being righted. All this happened without Greece's histrionics, Italy's foot-dragging, France's carping about austerity or Spain's shrill demands for help. In an article, Vitor Gaspar, the Portuguese finance minister, says Portugal frittered away the lower borrowing costs brought by the euro through consumer spending that produced little growth. The experience, he tells critics of austerity, shows that "stimulating demand does not guarantee economic growth".

The economists' charts may point the right way, but the benefit is not being felt by citizens, at least not yet. The recession has been deeper than expected, unemployment is forecast to reach 19% and the debt-to-GDP ratio now exceeds 120%—close to that of Italy. Credit for small- and medium-sized firms is especially tight. Portugal's exports are not large enough to lift the whole economy, as in Ireland, and some doubt they can be sustained when its main European trading partners are in recession or are tightening their belts. Investors question whether Portugal can regain access this year to capital markets. If growth does not pick up, a second bail-out may be necessary and debt may have to be written off, either overtly or covertly by easing lending conditions.

The euro zone's warm praise for Portugal draws attention to its own failings. For some economists, such as Megan Greene of Maverick Intelligence, Portugal is "the clearest example of how austerity is killing the patient". Those involved in the programme retort that Portugal shows only that internal devaluation within a single currency is "brutal stuff"; regaining competitiveness involves pushing down wages and prices.

Yet growing doubts about this prescription feed political resistance. Portugal's Socialists have distanced themselves from the programme, and Lisbon has started to see anti-austerity protests. Now the courts have become involved, too. One may wonder if judges are best placed to make economic policy or to rule dispassionately on public-sector salary cuts. But the ruling shows that creditors like Germany are not the only ones that must contend with awkward constitutional courts; a debtor like Portugal has its own Karlsruhe.

What nobody can tell is how far rejection of euro-zone conditionality in one country may encourage recalcitrance elsewhere. Financial contagion may have been contained for now by the European Central Bank, but political contagion is a growing risk. Unless growth returns the day may come when one country decides, as with the gold standard in the 1930s, that the pain of adjustment outweighs the risks of leaving. In Cyprus, where the banking sector is in ruins and capital controls have been imposed, exit already seems less scary than it did.

The prize in Lisbon

To be fair, the euro zone has been quietly adapting its policy. Deficit-cutting targets are being relaxed in response to the recession; Portugal has already been given an extra two years to bring its budget deficit below 3% of GDP. Germany has acquiesced in higher wages. But the American treasury secretary, Jack Lew, was right this week to urge Germany to do more to boost demand. Whether German consumers choose to buy Portuguese shoes with any extra money is a fair question. Still, if only to respond to growing political strains, Germany should be readier to help debtors to adjust.

It should start by agreeing to extend the repayment maturities for deserving cases. If Ireland and Portugal can return to the markets this year, despite all that has gone wrong, it would boost confidence in the euro. And it would allow Germany to claim that its harsh medicine was working.

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