Opinion

This Merkozy agreement is not worth a fig

Imposing austerity on everyone in the eurozone will never work, except to guarantee permanent depression

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And the winner was — David Cameron. With European markets collapsing after last Friday's "historic" summit meeting, with France about to lose its credit rating and with the German parliament seething at Angela Merkel's failure to deliver on her promise of automatic sanctions for breaches of the budgetary ceilings, it looks like the new eurozone treaty may not even be written, much less signed or ratified. Far from isolating or weakening Britain's position, the Prime Minister has protected the fundamental EU treaties from ridicule and disrepute.

As details of the Franco-German "fiscal compact" emerged over the weekend, it became clear that this "comprehensive" and "final" response to the eurozone crisis was no more comprehensive or final than all the previous failed summit deals. The only truly firm decision taken last week was to hold another meeting in three months' time. At that point, all the impossibly contentious issues dividing France and Germany would somehow be miraculously resolved. Until then, eurozone citizens and global investors will be right to remain sceptical. The reasons for scepticism can be grouped under three headings: finance, politics and economics.

Starting with finance, the summit deal completely failed to satisfy the two conditions necessary to restore confidence among the creditors to eurozone governments and depositors in the Greek, Italian and Spanish banks. First, the eurozone must be converted into a genuine fiscal union. Second, the European Central Bank needs to provide potentially unlimited financing to the weaker euro governments to bridge the gap between the political timetable for creating a fiscal union, which will take several years, and a market timetable that is measured in weeks or months.

> The ECB produced a scheme that is close to money laundering

The summit deal failed utterly on both these counts.

A fiscal union of the kind required to save the euro would require strong centralised control over national tax, spending and social welfare, which is what the Germans want but the French and Club Med countries resist. But to have any chance of restoring financial stability, the fiscal union would also need to create collective responsibility for sovereign debts and bank solvency in all the member countries. This is what the Mediterranean countries desperately needed to reassure creditors and bank depositors and it is what Germany refused even to discuss.

To make matters worse, the process of fiscal union has not been backed as expected by the ECB. Far from increasing support for Greece, Italy and others, the ECB reduced its purchases of their bonds to just €635 million last week (from as much as €20 billion previously). Instead of offering Italy and Spain bridging loans, the ECB produced a bizarre plan to lend money covertly through a cockeyed scheme that in another context might be described as money laundering.

The ECB announced last week that it will offer all banks in the eurozone loans for three years in unlimited amounts, at an interest rate of just 1 per cent. The banks will then be able to use this money to buy bonds issued by their own governments, in most cases yielding 6 per cent or more, thus picking up five percentage points of profit by hoovering up whatever debts their governments might choose to issue in the months ahead.

Given the ECB's offer of unlimited financing, the only limit on the banks' bond purchases will be set by their fears of a government default. If the Greek or Italian governments default on their debts, the Greek and Italian banks will go spectacularly bust — but these banks will go bust anyway if their governments ever default. Thus all the incentives for bank managements are to go for broke, risking their entire capital in the government debt markets and making maximum use of the new ECB credit lines.

Turning from finance to politics, the proposed treaty can only exacerbate the tensions and uncertainties threatening the eurozone's cohesion. Consider some of the questions raised by the treaty that nobody at present can answer.

Will all the 17 euro nations ratify the new treaty and how long will this take? Will Ireland be able to avoid a referendum in a period when Europe is viewed by the public as a hostile colonial power? Who will enforce the treaty's provisions, if Britain's exclusion means the 17 cannot have recourse to the European Court, the Commission and other institutions of the EU? Will all euro members insert German-style debt brakes into their constitutions to the satisfaction of the German courts? And if one country fails to do this, will it be immediately expelled from the euro?

> It would aggravate unemployment and economic stagnation

Worst of all, how will this deal interact with French politics? With the French presidential election approaching in May, what will happen if President Sarkozy's two opponents, Marine Le Pen and François Hollande, denounce the "fiscal compact" as a betrayal of French sovereignty and democracy? In that case, last Friday's agreement will not even be worth the paper it is written on until after the French election on May 6.

The third objection to the Merkel-Sarkozy agreement is its economic incoherence. Imposing Germanic austerity on all the other eurozone members simply cannot work as a matter of arithmetic and macroeconomics. Even if the fiscal compact could be immediately put into practice and even if the ECB backed it with monetary support, it would fail because it would aggravate the economic nightmares of unemployment and stagnation in Southern Europe, Ireland and ultimately also France and Germany.

It is arithmetically impossible for all the countries in the eurozone simultaneously to deflate their way out of a debt crisis. In this respect at least, Keynes's key insight of the 1930s — that workers and taxpayers are also customers — remains as relevant today as it was then. By imposing permanent austerity on the whole eurozone, the fiscal compact would guarantee permanent depression. And that in turn guarantees that the treaty supposedly agreed last Friday will never see the light of day.

You, the editor

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