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# The biggest danger for the euro is the lack of trust

By Philip Stephens Author alerts

## The argument between Italy and Germany asks a question at the heart of the currency's future


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Listening in on the altercation between Rome and Berlin about the inviolability or otherwise of the eurozone's fiscal rules, it is tempting to conclude that an irresistible force is hurtling towards an immovable object. Tempting, but misleading.

The argument between Italy's Matteo Renzi and Germany's Angela Merkel is real enough. It asks a question at the heart of the future of Europe's single currency. Can an arrangement that will always fall well short of a textbook monetary union be at once economically robust and politically sustainable? Germany – joined by other northern states – likes to focus on the first of these conditions; Italy and other more indebted economies on the second. The two, of course, should be seen as self-reinforcing. The challenge is to find the equilibrium.

On some things Berlin and Rome agree. The other day I heard a senior member of Ms Merkel's government remark that the eurozone's most precious asset is credibility. A week earlier one of Mr Renzi's colleagues offered precisely the same judgment at a private gathering in Rome hosted by Aspen Institute Italia.

The common ground extends to the urgency of structural reforms. The Italian prospectus begins with a call for more economic integration in the EU – specifically the extension to services of the single market. Governments should also throw their weight behind opening Europe's markets through a transatlantic trade and investment pact with the US. Closer to home, the emphasis should be on reforms to liberalise labour markets, on measures to promote investment and incentives for research and development.

The list of must-do's offered by Berlin is striking for its similarities: deepening the single market, lowering barriers to employment, recasting EU structural funds to promote growth, drawing in private investment for infrastructure and nurturing digital industries.

So where is the argument? Crudely put, it runs as follows: Ms Merkel says that fiscal restraint provides its own pathway to growth – German ministers now talk about "growth-friendly consolidation". The Italian response is that an unpopular programme to liberalise the economy may well require a breathing space on the budgetary timetable.

More supply is not much good without demand. To Mr Renzi's mind, investment that raises Italy's long-term growth potential (and thus creates more room to pay down debt) should be treated separately from current spending. To which my German friends retort there are no such things as "good" and "bad" borrowing. There is only borrowing.

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Both have right on their side. Ms Merkel faces domestic political pressure to talk up the credibility that comes with persuading markets that governments will stick to the rules of the growth and stability pact. Tearing these rules up in 2005 (Germany and France were then the culprits) prefigured the Greek debt explosion and the subsequent crisis.

Italy, with the same eye on domestic politics, worries about political credibility. This rests on a resumption of growth. Germany may be right to argue that a stable debt and deficit framework is a prerequisite for growth, but if markets conclude the remedy is killing the patient, then the whole system would lose credibility.

A reforming Italian government sticking to the letter of the fiscal law would not be much use if it were turned out of office by a populist revolt. I remember well the British government's vain efforts to keep sterling in the European exchange rate mechanism. The higher it raised interest rates, the more convinced the markets became that such hikes were not politically sustainable.

For all that, the divide is narrower than it looks. One of the lessons of the eurozone crisis is that rhetoric intended for domestic consumption is tempered by realism when leaders arrive in Brussels. The legions of economists and hedge fund investors who in 2012 predicted the certain demise of the euro badly misread the politics of the crisis. They overlooked the gap between public positioning and private pragmatism, and underestimated the political resolve.

Greeks marched against austerity while insisting they would remain part of the eurozone. Germans refused to underwrite the debts of weaker partners and then proceeded to do just that. Economists were left with egg on their faces. Hedge funds are now piling into peripheral economies with the reckless abandon that saw them take flight in 2012.

To say the acute phase of crisis has passed, however, is not to conclude that the euro has been fixed. To adapt an observation once offered by Alexis de Tocqueville, the most dangerous moment may yet arrive during the process of reform. In the circumstances, a long public argument around rules versus flexibility would be as futile as was the earlier debate between austerity and growth. In both cases, the eurozone requires both.

Ms Merkel has to be persuaded that any loosening of the fiscal reins is not an excuse for heavily indebted eurozone members to ease up on efforts to strengthen the underlying productivity of their economies. Mr Renzi has to know that if he delivers on economic reforms he will not be floored by overzealous interpretation of the budgetary rules.

The debate, in other words, is as much about sequencing as about the desired economic destination. What makes things tricky is that the two leaders each feel compelled to claim victory in order to satisfy their domestic political constituencies. Credibility, Ms Merkel and Mr Renzi agree, is the key to the euro's future. Finding the equilibrium, they should now recognise, requires above all else the establishment of trust.

philip.stephens@ft.com

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