Germany can’t solve this alone

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Northern and southern European countries have constructed their economies around incompatible systems, and adoption of the euro has only worsened the division. Could Germany now consider returning to a more flexible monetary system?

The Federal Republic of Germany had no desire to run Europe after the second world war. All its political leaders, irrespective of party, saw that Germany had a fundamental problem with its neighbours: it was too big to be loved and too small to be feared. So it had to throw its lot in with a wider European project, which it could direct together with other nations, including France. A place on the international stage mattered little, as long as Germany had guaranteed access to foreign markets, was able to obtain raw materials and could export manufactured goods. Maintaining this protective European environment was so important that Chancellor Helmut Kohl (1982-98) always did whatever he could to preserve European unity, or the semblance of it, when frictions arose between members. He footed the bill.

Angela Merkel’s government faces an entirely different challenge today. Seven years into the financial crisis, all the countries in the EU, and some outside it, are looking to Germany to come up with a solution, and many expect a Kohl-style one. But current problems are much too severe to be solved by Germany just paying. The difference between Merkel and Kohl is not that Merkel aspires to lead Europe: it is that the situation requires her — whether she wants to or not — to move centre stage.

That won’t be easy. Integration has led to economic and political disaster across Europe. And Germany, which has become a sufficiently significant player to be accused of responsibility for all Europe’s ills, is too small to provide remedies. Domestically, Merkel’s centrist consensus is in danger of falling apart. In Europe, those seven years have diminished the goodwill that post-war German governments built with their neighbours. In Mediterranean countries, and to some extent in France, Germany is more hated than at any time since 1945. There have been cartoons showing Germany’s leaders in Wehrmacht uniforms and swastikas. For political contenders on both right and left, one of the surest ways to win an election is to campaign against Germany and its chancellor.

The European Central Bank (ECB)’s implementation of quantitative easing has been hailed in southern Europe as a victory over Germany. In Italy, ECB president Mario Draghi, though a former employee of Goldman Sachs and a fervent neoliberal, isregarded as a national hero for having got one over on the Germans. Nationalism is resurgent across Europe, including in Germany, which used to be the least nationalistic of countries. Foreign policy in southern Europe now means trying to wrest concessions from Germany in the name of national interest, European solidarity or even all of humanity. No one can predict how long it will take to heal the wounds caused by the EU in relations between Germany and Italy and Greece.

‘Save first, spend later’

Through an irony of history that Merkel must be aware of, economic and monetary union (EMU), which was supposed to consolidate European unity once and for all, now stands a good chance of shattering it. German politicians are beginning to realise that the conflict is not about saving the Greek state or French (or German) banks, and that skilful surgical intervention will not restore unity. It affects the very structure of the eurozone, which brings together disparate societies, with very different institutions, cultures and practices, reflected in the different social contracts that regulate the relationships between modern capitalism and society. And these divergent political economies have very different monetary systems.

In broad terms, the Mediterranean countries developed a model of capitalism in which growth was driven mainly by domestic demand. If necessary, growth could be stimulated by inflation fed by public deficits and encouraged by powerful unions, which guaranteed security of employment, especially in the public sector. Inflation allowed these states to borrow more readily as it also devalued their debt. These countries also had tightly regulated public, or semi-public, banking systems. In theory, all these factors combined to ensure relative harmony between workers' and employers' interests, especially in small firms that sold their products on the home market. But social harmony came at the cost of international competitiveness, and a lack of that had to be compensated for by periodic devaluations of the national currency, to the detriment of export businesses. And this policy depended on the state being in control of its national currency.

The northern European economies — especially Germany — operate on a different model. As their growth is export-driven, inflation is the enemy. That holds true for workers and unions, too, especially now that rising costs can lead to businesses relocating. Economies of this sort do not rely on the option of devaluation. Whereas Mediterranean countries — including France — have in the past benefited from monetary flexibility, countries such as Germany have found a rigorous monetary policy suits them very well. That is why debt is also an enemy, even if, with low debt levels, they generally enjoy low interest rates. And as they do not need monetary flexibility, they avoid the danger of stock market bubbles. Such a policy benefits their many savers. The saying "*Erst sparen, dann kaufen*" (save first, spend later) sums up the attitude Germany's political and economic institutions have traditionally encouraged.

A monetary system cannot simultaneously work in favour of savings-and-investment-based economies, as in northern Europe, and southern economies based on borrowing and public expenditure. Therefore one model has to yield to the other, reforming both its mode of production and the social contract on which it is based. Currently, the Mediterranean countries face a treaty obligation to become competitive, with Germany in the role of a guarantor of monetary discipline. But their governments do not want to do this — nor are they capable of doing so, at least in the short term.

'Lazy Greeks' and 'austere Germans'

As a consequence, battle lines in the eurozone are drawn for a conflict which will be all the more brutal as its impact will be felt not just on incomes but on whole ways of life. That much is clear from the stereotypes that contrast "lazy Greeks" with "austere Germans" who "live to work instead of working to live" and seem like inflexible taskmasters because they defend both EU treaty obligations and their own form of capitalism. Southern Europe's attempts to introduce some flexibility in the eurozone, which would allow these countries to return to the inflation rates, public deficits and currency devaluations that their economies have depended on, have been opposed by northern states and their electorates, who refuse to be lenders of last resort for their southern neighbours.

But though the eurozone countries are incapable of convergence, they do not want to separate, at least not yet: northern Europe's exporting nations value fixed exchange rates, while the southern countries want interest rates as low as possible, in exchange for which they are willing to accept limitations on their deficits, in the hope that their EU partners will show more clemency than the markets.

Currently, Germany and its allies have the upper hand. In the longer term, no one can afford to lose the battle: the losers will have to reconstruct their political economy and go through a long period of transition that will be uncertain and turbulent. So the southern countries could be forced to establish the same labour market system as in the north, and the Germans to end their obsession with savings, which their neighbours think is destructive and selfish.

In this context, the ECB's quantitative easing programme, with its declared aim of pushing inflation up to 2%, can be seen as part of a strategy that benefits the Mediterranean countries; it has also immediately translated into a lowered euro exchange rate. It is worth recalling that Enrico Letta, during his short tenure as Italy's prime minister (April 2013-February 2014), railed against the high rate of the "bloody euro" for hampering Italy's economic recovery. The problem is that such depreciation brings most benefit to exporting countries such as Germany, and does nothing to improve the situation in weaker economies. In the longer term, it could even trigger a *global* rush to devalue. And though

German export industries would not complain about a further improvement to their competitiveness, savers would have to put up with negative interest rates for a long time.

Competing models

Discussions about the future of European monetary union are not just technical; they are moral. It is worth emphasising that neither of these forms of capitalism is inherently better than the other. The establishment of capitalism in any society, a matter of improvisation and compromise, is never fully satisfactory. That doesn't stop the advocates of one model judging another model deficient because they consider theirs to be natural, rational and compatible with the highest social values. So the Germans don't understand that when they exhort the Greeks to "reform" their political economy — to reform themselves — to get rid of waste and corruption, they are asking them to replace the corruption traditionally rooted in Greek society with a modern, financialised corruption, intrinsic to contemporary capitalism.

The violent ideological and economic conflicts that are damaging Europe and fuelling nationalism have not run their course. Even if austerity ultimately makes southern Europe more competitive, it is estimated that it will cause a 20-30% reduction in living standards in debtor countries compared to pre-2008 levels. This system is being imposed with reassurances that market liberalisation will strengthen their economies, which can then make up ground and reduce the income gap. This is a fantasy, given the cumulative advantage that operates in these markets. Regional disparities, which have been made worse by austerity, will have to be reduced through a political solution within the eurozone, akin to the redistributive model employed by Italy in its south, and by Germany in its new *Länder* post-reunification. Yet the 4% of GDP these countries allocate to those regions has only a modest impact on widening interregional income gaps.

Economic disparities will cause conflicts between and within eurozone countries. The southern countries will demand growth programmes, a European Marshall plan and regional policies to help build a competitive infrastructure and material solidarity in exchange for their support for a single market and European unity. For economic and political reasons, the northern governments will not be able to provide more than a small part of the necessary funds. In return, they will demand oversight of how their money is spent, even if only for domestic political reasons: their oppositions will accuse them of waste, cronyism and corruption. The southern states will resist the encroachment on their sovereignty by the north, and will criticise their parsimony.

Germany, as the biggest and probably the richest of the member states, will be blamed for its political imperialism and economic self-interest, but will not be able to do much about it: the electorate will not let the government give unconditional support to southern countries and will refuse to finance a European regional policy while they are still paying for the former East Germany.

How long will Merkel's grand coalition be able to keep both its EU partners and the electorate onside? It may soon run out of resources. German exporting industries and the unions have made the pursuit of monetary union an absolute priority and, with the support of a euro-idealist left, have turned the euro into a sacred cow. Merkel, always tuned in to her support base, told the Bundestag in September 2011: "If the euro fails, Europe fails." So she has resigned herself to making painful and humiliating concessions, in particular during the vote in parliament on the "salvation plans" for Greece.

Eurosceptics in Germany too

The German government — which functions as the executive committee of its export industries — may be ready to sacrifice itself for the survival of the euro. But the prevailing consensus in favour of European integration has fractured. Euroscepticism has suddenly appeared in Germany. A new party, Alternative for Germany (AfD), is threatening the CDU from the right (see "Alternative Germany"). To resist it, the centrist parties, including the social democrats, need to refrain from making any concessions other countries might demand. Until now, the internal transfer of funds within the EU and eurozone was often hidden in regional or social European funds. Now monetary union will require considerable sums impossible to conceal — not just to "save" Greece but also to sustain it after it's been "saved".

Various grievances brought to the European Constitutional Court have tried to politicise the question of Europe and stir up German public opinion. For a time, Merkel's government seemed to tacitly approve the inventiveness with which the ECB was circumventing the ban on direct loans to member states, even though the Bundesbank protested. But as the conflict over resource distribution between eurozone countries will soon be a chronic problem, the political and economic cost of monetary union will perhaps become so exorbitant that the German government will not be able to hide or defend it, especially in a context in which Germans are sorely tested by austerity.

Although Germany has put the euro on a pedestal, it could manage without it. To balance out economic performance across Europe, it may be better to give some monetary control back to individual European countries and a wider margin for manoeuvre to the south (and southeast, which hopes to join the zone), rather than stick with the single currency. Doubts about this system's viability are growing, even in Germany. Even if the Germans are right to think that in some circumstances austerity is good for economic health, in practice it cannot work miracles without a devaluation of national currencies.

The cohesion of the eurozone now rests solely on the fear of what would happen if it broke apart. But that may not be enough to convince German voters to keep backing it. Faced with a growing tide of nationalism, political elites may come to the conclusion they should stop equating Europe with the euro and listen to the increasing number of economists, including German ones, who advocate a more flexible, less unitary monetary system, more like the European exchange rate mechanism of the 1980s. This solution is unlikely to be a panacea, but there is no ideal answer in a capitalist economy riven with internal contradictions. German exports would probably suffer for a time, but the lot of taxpayers and the reputation of their country among their neighbours might improve.

Merkel managed to effect a radical change of position on nuclear power. And it is not inconceivable that she could even be remembered as the chancellor who freed Europe from a single currency that had become a nightmare.