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Germany and the Future of the Eurozone

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Although the euro has survived the most severe phase of the current crisis, its future is still uncertain. The fate of the common currency will depend not only on the condition of the European economy, but also the priorities of its biggest player—Germany. So far that country has been strong enough to enforce its own vision of integration based on neoliberal reforms and austerity measures. Since the side effects of this prescription have been rising costs and risks, Berlin's new government will consider a range of different solutions, including in extremis a controlled and partial break-up of the Eurozone. For Poland, this volatility creates a challenging environment with risks, but also creates chances for Warsaw to increase its influence over the evolution of EU integration in this field.

The European Monetary Union is entering an awkward year. Many of its member states are still plagued by high unemployment, economic stagnation, indebtedness and a rising Euro-scepticism at the popular level. Some economists see this as a long-term state for the EMU. Larry Summers, the former U.S. Secretary of State, recently predicted decades more of muddling through the crisis[1] particularly in Europe. And yet even the most weakened economies of the Eurozone are displaying signs of stabilisation or even recovery. Under these circumstances it is not easy to predict the future of the common currency. Neither a "sudden death" through chaotic collapse nor an "easy ride" with a smooth rise to a political union are probable. Rather, there are three options worth considering.

The first is a continuation of the neoliberal mode of integration, aimed at fiscal austerity, supply-side reforms and international competitiveness. This is supposed to lead to a convergence of economic models and smooth the path to deeper political integration. At present, such efforts are stuck at an inter-governmental level of management. The second option is the achievement of a Keynesian political union. The main feature of this scenario is the euro's role as a springboard for supranational executive bodies that carry out interventionist economic policies, including various forms of financial transfers to the peripheries of the Eurozone and market regulation. The third possibility is a system of "diversified integration" with the Eurozone shrinking to a core of stronger economies or becoming a loose alliance of currencies with temporary exits possible. The painful convergence of EU economies would no longer be necessary, but the chances of a political union would fall to zero.

[1] Larry Summers at IMF Economic Forum, 8 November 2013, Youtube.

Asymmetric Convergence

The first scenario seems to have the strongest proponents in Berlin. The conservative parties—CDU (Christian-Democratic Union), CSU (Christian-Social Union), the Liberals from the FDP, but also many circles among the Social Democrats, support the view that before a deep political union, Member States must converge in terms of productivity and macroeconomic standards. To be more precise, however, convergence means getting closer to German standards. In future, therefore, Greece should cut budgetary spending, make the labour market more flexible, lower costs and become more competitive in the global economy—just like Germany in the last 10 years.

Moreover, economic convergence should never be outstripped by political integration. Indeed, a tradition has emerged in Germany whereby any institutional progress at the European level excites angry memoranda signed by dozens of professors and experts[2]. The real stumbling block, however, is the Constitutional Court in Karlsruhe, which has the power to decide on the legal status of new integration measures. The threat of judicial activism has been very convenient for Berlin as a means of keeping political integration under inter-governmental control and enforcing concessions from other players. The last negotiations around the banking union were a case in point: even Germany's Martin Schulz, President of the European Parliament, called them a "brutal power policy."[3]

Of course, this reform model, which can be labelled "asymmetric convergence," is not really new. It was successfully applied in the 1970s, when European monetary integration began. At that time France wanted a common central bank as a starting point for economic convergence. Instead, Germany pushed through the thin and technocratic European Monetary System, which enabled the Bundesbank to bring the whole European Community onto an anti-inflationary course. The difference today is that asymmetric convergence should also encompass other crucial areas of the economy, including fiscal and labour market policies.

Keynesian Union

The most obvious alternative to asymmetric convergence—namely, moving ahead to a political union with interventionist components and "symmetric" convergence—has fewer friends in Germany. It is mostly written off as a transfer union, a method of shifting wealth from the efficient core to the peripheries. This is why the social-democratic SPD, a party naturally prone to Keynesianism, puts more weight on domestic German measures, such as the minimum wage and higher pensions, which have the potential to trigger domestic consumption and some kind of EU-wide redistribution, rather than on Eurozone-level measures such as Eurobonds. The Greens are likely to follow suit.

The only party that can be fully associated with relatively quick political integration and non-liberal economic policy is Die Linke (the Left Party). Sarah Wagenknecht, deputy chairwoman, focuses on the sovereign-debt/banking nexus and claims that the Eurozone needs a reduction in all government debt over the threshold of 60 per cent of GDP, which will also lead to a "downsizing" of the overblown investment banking sector. Governments should prop up only those banks that deliver loans to companies. Another revolutionary idea is that the European Central Bank should provide credit directly to states.[4] Such views, however, have cemented Die Linke's outsider status.

And yet, the relative political isolation of Die Linke cannot hide the fact that a rising number of experts provide good arguments for more political union and a different economic policy. In July 2012 a group of renowned economists, including Lars Feld, Beatrice Weder die Mauro and Peter Bofinger, published

[2] FAZ, *Protestaufruf: Der offene Brief der Ökonomen im Wortlaut*, 2013, www.faz.net/aktuell/wirtschaft/protestaufruf-der-offene-brief-der-oekonomen-im-wortlaut-11810652.html, updated 27 December 2013.

[3] "Europa-Politik: EU kritisiert Kanzlerin wegen Bankenunion," *Spiegel Online*, 2013, www.spiegel.de/politik/deutschland/eu-kritisiert-merkel-wegen-bankenunion-a-939112.html, updated 28 December 2013.

[4] S. Wagenknecht, "Freiheit statt Kapitalismus: Über vergessene Ideale, die Eurokrise und unsere Zukunft," dtv, 34783; Aktualisierte und erw. Neuausg., ungekürzte Ausg, Dt. Taschenbuch-Verl, München, 2013.

a paper supporting a full banking union and underlining the necessity of upgrading the European Stability Mechanism (ESM).[5] Another example is the manifesto of the "Glienicker Gruppe"—a team of economists and political scientists who advocate joint measures regarding the financial sector, economic support for the crisis-ridden countries (e.g. common unemployment insurance) and production of substantial public goods on the European level. This requires a Eurozone economic government, acceptance of deeper Eurozone integration, a new treaty to keep the sophisticated construction together, and possibly the emergence of a two-speed Europe.[6]

Maintaining the Eurozone as a Core

An end to the Eurozone as it is today would be the least popular option in Germany. Too much is at the stake, ranging from the Eurozone as a market for German products to the political future of the continent. However, the idea of a partial break-up enjoys some support across the usual political divisions, in business and in academia.

The strongest voice against the Eurozone in its current form comes from liberal-conservative circles. Their loudest representation is the Alternative for Germany (Alternative fuer Deutschland, AfD), a new party that only barely fell short of the threshold for entry into the Bundestag. Scepticism is also *en vogue* in the Bavarian CSU. It was one of the CSU leaders, Peter Gauweiler, who filed a constitutional complaint in Karlsruhe against the EMU. Another prominent member of the "anti-euro" lobby is Frank Schaeffler from the FDP. But even in Chancellor Merkel's CDU this line of thinking is hardly a rarity. Criticism towards the euro from mainstream politicians is fuelled by the fears of voters, reflected in newspaper headlines and opinion polls, but also the opinions voiced by many renowned economists.

This group uses quite a cohesive set of arguments: monetary union should never have been created, since it ignores the fact that the European states differ very much from each other. In the past this divergence was cushioned by monetary sovereignty and adjustable exchange rates. With such mechanisms no longer available, Member States should have extremely flexible labour markets or accept a fiscal union. And yet neither condition is either possible or acceptable, and thus the crisis is a structural one. AfD speaks for many when it comes to the conclusion that the euro is an "apple of discord"—inessential for Germany and harmful for other countries.[7]

Their preferred way out of the crisis is the reduction of the Eurozone to a core of similar economies, without the "southerners." Hardliners would go even further and return to the German Mark, while doves see a "breathing euro" with temporary exits for reforms as a more convenient option.[8] Whatever the small print, nobody questions the necessity to defend the common market as a base for integration and the need to support countries leaving the Eurozone. But in this vision, such support would not entail transfers, but rather a massive debt cut, charging the financial sector: in effect making it a liberal solution to the crisis, in which investors are held responsible for their failed investments.

Concepts for a regulated dissolution of the Eurozone also come from other political corners. A joint report by Heiner Flassbeck, former chief economist at the UN, and Costas Lapatitsas, of the left-wing Rosa-Luxemburg-Foundation, garnered much publicity in May 2013 by claiming that since a managed recovery was too expensive to achieve, a regulated break-up of the Eurozone was the better option. In order to avoid a collapse on the part of the "exiting" economies it is necessary to introduce control over capital movements at their borders and prevent deep depreciations of their new national currencies. The European Monetary System could be a very useful stabilising instrument in this context.[9] From this left-wing perspective, the disintegration of the Eurozone might also shrink the power of the financial sector and

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5 "Breaking the Deadlock: A Path Out of the Crisis," *INET*, 2012, accessed 27 December 2013.
6 "Glienicker Gruppe," 2013, www.glienickergruppe.de/english.html, updated 18 October 2013.
7 "'Der Euro ist ein Spaltpilz für Europa', Das Interview mit Bernd Lucke," *Handelsblatt*, 16 May 2013.
8 H.-W. Sinn, *Europa: Die offene Währungsunion*, 2013, www.zeit.de/2013/45/waehrungsunion-konzept-glienicker-gruppe, updated 14 November 2013.
9 H. Flassbeck, C. Lapavitsas, *The Systemic Crisis of the Euro—True Causes and Effective Therapies*, 2013, accessed 28 December 2013.

restore the position of social organisations, trade unions and national parliaments. Broadly speaking, this is the thesis of Wolfgang Streeck, the influential director of the Max Planck Institute in Cologne, who combined a criticism of neoliberal capitalism with a proposal to return to national currencies in the European Union.[10]

Future Prospects

Currently, Germany still prefers the neoliberal and asymmetric solution for bringing the Eurozone out of the crisis. But the experiences of 2013 showed that this method has some clear limitations. First, the economies subjected to harsh fiscal contraction have stabilised in stagnation and high unemployment. It is doubtful that the continued application of austerity measures will bring recovery, while it is certain to bring political tension. Greece and Italy in particular face the danger of a political breakthrough of Euro-sceptic populism.

Second, Germany is not, despite its economic power, strong enough politically to enforce supply-side reforms, in particular in the labour market, in crisis-ridden economies. A desperate German attempt to force through so called reform contractsw in the EU ended up putting Berlin in political isolation during the last EU summit in December 2013. The Finnish EU Commissioner, Olli Rehn, reprimanded Chancellor Merkel, pointing out that "Germany is, after all, one of 28 countries" and cannot dictate the reform agenda.[11] This might be the moment that will be remembered as a return to more balanced relations within the EU.

Third, the German method has left institutional chaos in its wake in terms of integration arrangements. The new instruments of economic governance introduced after 2009 do not create a coherent and logical system. Moreover, they are dramatically dependent on inter-governmental negotiations. It should not be surprising that under these circumstances the ECB, the only supranational body truly autonomous of governmental interference, has filled the power vacuum and taken over responsibility for dealing with the crisis. Interestingly, the actions taken by the ECB have clashed with German priorities—yet another sign of the weakening position of Berlin.

Of course, such limitations do not suggest that asymmetric convergence is over as a method of integration. But it is a possibility if the crisis returns. What would Germany do in such a scenario? Would it move grudgingly towards a Keynesian political union and greater symmetric integration, decide to dismantle the Eurozone, or indeed try to look for another way to break the deadlock?

It can be assumed that the chances of a political union are very slim now and in the near future. German taxpayers fear a transfer union and some political players are ready to reclaim this area. Other "northerners" are even more radical. As *Der Spiegel* columnist Wolfgang Muenchau pointed out in this context, "the Dutch are more German than the Germans, but Finland is more Dutch than the Netherlands."[12] In this climate, Berlin will simply try to continue to push for asymmetric convergence by buying more time. One tactic for achieving this might be the provision of "domestic" Keynesianism, with measures such as the minimum wage or higher social spending—which can also be stylised as demand drivers for products from the south. Another step might be to trim public debt, or instigate joint programmes to revive the EU labour markets. However, the common feature of such measures is that they will be costly, and not necessarily effective. However, they can help to maintain the status quo and put a brake on any downgrading of integration.

Yet it is hard to exclude the possibility that this policy could at some point lose support, and Germany will decide in favour of a partial dismantling of the current monetary union. But in that case, Angela Merkel and SPD leader Sigmar Gabriel would do everything possible to secure other areas of integration and smooth

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[10] S. Wolfgang, *Gekaufte Zeit: Die vertagte Krise des demokratischen Kapitalismus*, Suhrkamp, Berlin, 2013.
[11] "EU-Kommission: Oettinger und Rehn warnen vor deutscher Dominanz," *Spiegel Online*, 29 December 2013, www.spiegel.de/politik/ausland/rehn-und-oettinger-warnen-vor-deutscher-dominanz-a-941109.html.
[12] W. Münchau, "Das Undenkbare durchdenken," 2014, www.spiegel.de/wirtschaft/parallelen-zwischen-erstem-weltkrieg-und-Euro-krise-a-941317.html, updated 3 Jan 2014.

the shift to another form of monetary co-existence. This means for example the creation of a fund designed to protect new currencies against entering into freefall, or even the introduction of temporary capital controls. The second important element could be a clear road map stressing the temporary character of the new 'euro-outs' and establishing conditions for a successful comeback. This arrangement as a whole has political appeal. It neutralises the enemies of the euro, whilst keeping the enterprise alive.

Poland will not join the single currency until at least 2020. But it has definitive and clear interests in cautiously observing the evolution of the Eurozone. Two scenarios seem particularly important. The first is the possibility of the Eurozone quickly turning into a political union, which would cause Poland's peripheral status to become deeper and its impact on crucial decisions less than it is today. But the opposite development—a collapse of the Eurozone—brings the danger of a domino effect and the incremental demise of the European Union.

From this perspective, current German policy, which keeps political progress slow and tries to force economic convergence via supply-side reforms, is a good deal for Warsaw. It certainly does not endanger the competitive profile of Poland, which is based primarily on low labour costs. Indeed, compared to the Keynesian approach, even the controlled shrinking of the Eurozone would be a less daunting prospect than is widely perceived. This second best solution not only saves the overall structure of integration. It also introduces greater flexibility into the process of monetary integration and may help to structure the derogation status in a better way. Primarily, it also means a louder political voice, by changing rules within the core. Another advantage, as Hans-Werner Sinn pointed out, is the possibility of taking some steps towards the core without the danger of being involved in rescue transfers for richer but crisis-ridden members[13]. Last but not least, such an arrangement lowers the pressure in internal debates about EMU membership, since it is gradual and reversible.

[13] H.-W. Sinn, *op. cit.*