

Germans to the front in Europe

By David Marsh

Barack Obama, the US president, has been stepping up trans-Atlantic telephone diplomacy to encourage Germany, France and Spain to take action to limit worldwide fall-out of the European debt crisis.

However, Obama's fears that the euro mess could lead to a refreezing of worldwide banking markets and derail the global economy are nothing compared to the worries experienced in the euro's heartland, Germany.

For the first time, problems in the periphery of Europe are striking home in the centre of the euro area. Germany's reaction to what Chancellor Angela Merkel calls an "existential challenge" for the euro is gradually becoming clearer. And it is not something that its neighbours and allies will be very keen to hear. The irrefutable message being relayed at home and abroad is that Germany is seeking gradually to take control of the European economy -- in a last-ditch response to what Berlin sees as other countries' widespread failure to put their house in order.

During repeated currency crises over the past half a century, Europe's difficulties never hit home directly in Germany itself. If the going got rough, the Germans could withdraw to the impregnable fastness of the mark. That protection is no longer intact, because the currency intrinsically affected by the failures of Europe's periphery has become Germany's own money.

John Connally, President Nixon's Treasury Secretary when the Americans severed the dollar's links to gold in 1971, was able to say laconically to European finance ministers: "It may be our currency, but it's your problem". The German message vis-à-vis the European periphery is now: "It's your problem -- but it's our currency."

There are three components to the new German message. First, Germany is becoming more self-centred. Chancellor Merkel's recent statements to the German parliament, and steps in areas like cracking down on short-selling on securities markets, make clear that the Germans will be introducing go-it-alone action if they feel this is warranted by their own circumstances.

Second, at least in the short term, Germany will rely more on exports, and less on domestic consumption, to expand its way out of trouble.

Wolfgang Schäuble, the German finance minister, speaks reassuringly about Germany again becoming a "locomotive" for European growth. But recent data and projections indicate that exports will be in the driving seat of the German economy in the next two years. Last week's Economic Outlook from the OECD, for example, forecast that Germany's exports will rise 10% in volume terms in 2010 and 8.8% in 2011 -- comfortably ahead of import growth -- which will lead to a further increase in the German current account surplus. Private consumption, meanwhile, will fall 1.4% in 2010, and will rise only by an anaemic 0.7% in 2011. The fall in the euro and German angst about coming tax increases are likely to exacerbate these trends further. This is precisely the opposite of the economic rebalancing that the U.S. and other countries wish.

Third, Germany is likely to become more rather than less hectoring in its statements and recommendations to other countries in the euro area on how they should adjust their economies to cope with world-wide economic change. In her latest statement to the Bundestag on May 19, Merkel spelled out with unmistakable candour her plans for the new "stability culture" in Europe: "The rules will be geared not to weakest states but to the strongest states. I know that is this a tough message, but economically it is an absolute must."

When the euro was born in 1999, German leaders -- in particular, the then president of the Bundesbank, Hans Tietmeyer -- gave no shortage of warnings to states on the periphery that they would have to change their behaviour dramatically to cope with the new environment.

There could be no more devaluations, so countries from the euro's southern and western fringes facing competitiveness problems would have no option but to lower prices through massive cuts in government expenditure and rises in unemployment. Those warnings went unheeded for a decade -- and have now proved to be chillingly correct.

What the Germans did not foresee was the way that economic stress in peripheral states would feed through directly into financial problems in Germany itself. Somewhat illogically, Germany failed to foretell that the financial claims being built up on errant euro states would largely reside with the surplus countries of northern Europe whose banks would inevitably be financing the southerners' deficits. Hence the estimate of 700 billion euros for the indebtedness towards German banks of the five main problem countries Greece, Spain, Portugal, Ireland and Italy.

This has been the main reason why the Germans reluctantly have had to support the gigantic 750 billion euro package to rescue the single currency announced in the early hours of 10 May. The "no bail-out clause" embedded in the Maastricht treaty became unenforceable. Not because the banks carrying out the lending were too big to fail, but because the debts generated by euro imbalances had become too big not to bail out. To ensure that these debts do not cause immense trouble for Germany itself, Berlin is itself striding to the forefront of the economic governance of Europe.

There are already signs that other leading players in the euro area are taking heed of new German self-assertiveness. Yet there is no certainty over how the process will end. The euro was founded partly on the desire to limit German strength in Europe after the country's 1990 reunification. So the likelihood that the euro's travails will lead to exactly the opposite will be a matter for conjecture and even foreboding in many parts of Europe.