Germany seems poised to only ever do the minimum to support the euro

Public disgruntlement stops Berlin cementing a currency union that helps make the country an export dynamo.

In September 2008, UK authorities realised troubled mortgage lender Bradford & Bingley could topple the country's financial system. Belgium-based giant Fortis faced closure. The French administration of President Nicolas Sarkozy was battling to save Franco-Belgian lender Dexia. The German government of Angela Merkel was preoccupied with rescuing Hypo Real Estate. Then the three biggest Irish banks, whose balance sheets amounted to 700% of Ireland's GDP, tottered. A panic-stricken Dublin effectively bankrupted the country by guaranteeing the deposits and liabilities of the country's six largest banks.

To save Europe's financial system, the Dutch government proposed each country should establish bank-rescue funds on a common basis by contributing 3% of GDP, which would amount to 300 billion euros. Sarkozy supported the joint measures and invited the leaders of Germany, Italy and the UK to Paris to discuss the idea, which Italy quickly backed. But Merkel denounced the proposal and threatened to boycott the Paris gathering if it was called a "crisis" meeting. The summit went ahead but failed to agree on joint solutions. Sarkozy blamed Merkel. "You know what she said to me? Chacun sa merde. (To each his own shit)."

Now, German officials denied Merkel used such French. They said Merkel quoted Goethe in German that 'everyone should sweep in front of his door and every city quarter will be clean'. Whatever Merkel said, both responses describe Germany's ambivalent attitude towards securing the future of the euro during the global financial crisis and the eurozone debt crisis of 2010 to 2015.

Many times when the euro's future needed cementing, Germany watered down or refused joint solutions if they imperilled German taxpayers. Berlin vetoed fiscal-transfer solutions, ruled out sovereign debt pooling (eurobonds) and thwarted the proper banking union needed to snap the 'doom loop' between banks and governments. Berlin delayed, then constrained, European Central Bank remedies such as quantitative easing. It placed an inadequate cap on the European rescue fund. From 2010, to deal with Greece's insolvency, Berlin opposed the default the country needed, inflicted measures that impoverished Greek society and sanctioned bailouts that only rescued foreign banks. In 2011, Berlin imposed austerity across Europe when it tightened budget rules that enforced its balanced-budget obsession and (Hartz) micro reforms on southern Europe to boost competitiveness, despite the huge social costs inflicted. In 2012, Germany initially disowned ECB president Mario Draghi's 'whatever it takes' comment that saved the euro. In 2015, Germany's finance ministry formed a plan to eject Greece off the euro to create a 'firewall' around the eurozone and avoid a loss for German taxpayers.

Yet, over these years, Germany always did enough to preserve the eurozone, even at some risk and cost to German treasure. Despite domestic hostility, Berlin sanctioned the small rescue fund and authorised baby steps towards a partial banking union. Against Bundesbank opposition, Merkel permitted ECB asset-buying and swung behind Draghi's whatever-it-takes bluff by approving a conditional lender-of last-resort role that made the ECB less of a pretend central bank. She scotched the plan to eject Greece off the euro. In 2020, Merkel probably performed the biggest U-turn of her career when she approved a 750-billion-euro recovery package funded by eurobonds, to defuse the uncertainty created when the German constitutional court undercut the ECB's power to buy sovereign bonds. But the stimulus was a one-off, paltry and delayed.

Confusion about Germany's intentions for the euro has given birth to the German verb 'merkeln', meaning to dither. Germany's ambivalent attitude and minimalist approach to the euro could be tested again soon enough and possibly before Merkel retires as leader in September after 16 years as chancellor. The covid-19 pandemic has ravaged Europe's economy, jolted anew by a winter-wave of infections. Fiscal stimulus means eurozone government debt is poised to exceed the area's GDP for the first time – the ratio had reached 97.3% of output at September 30 last year. The euro is still a flawed currency because there is no way to resolve external imbalances between the 19 euro members. The area's banking system is undercapitalised. A stronger euro – around a record high in trade-weighted terms – is reducing Europe's competitiveness while intensifying deflationary forces that the just-about-out-of-stimulus ECB appears unable to combat.

Ultimately, the best solution for the currency union in its current state is for it to be enmeshed in a political and fiscal union that would allow German wealth to flow to weaker parts of the

eurozone. But German leaders are unlikely any time soon to take the breakthrough steps need to secure the eurozone for five reasons. The first is the natural selfishness of sovereign bodies as shown by how parochial Australian states turned during the pandemic. The second is that Germany's recent history makes it reluctant to lead. A third reason is the German view that its neighbours have heaped misfortune on themselves. A fourth is disquiet that the lax monetary policy of the ECB penalises German savers and subsidises undeserving southerners. The last reason, perhaps the most obscure, is that rising inequality in Germany acts against a consensus that Germany should dispense its resources to save Europe – after all, many Germans think it is they who need help. So only expect Berlin to do the minimum required to hold together the currency union in its present form.

To be sure, a big-enough emergency coupled with 'enlightened self-interest' could prompt Berlin to take grand steps towards the political and fiscal enmeshment the euro demands because if the eurozone fails Germany will suffer too. Debtor countries and other creditor countries could determine the destiny of the eurozone, not just Germany. No euro user, including any debtor one that might toy with leaving approaches Germany's pivotal position to determine the currency's fate. Even amid sporadic crises, the eurozone could stumble along as an incomplete currency union for decades yet. Germany has no intention of pulling out – the euro serves as a useful foil for German troubles and keeps German exports more competitive than would a return to the Deutsche mark.

It's just that, if need be, German policymakers will find it hard to win their population's assent to take watershed steps to secure the euro. While Berlin can only take a minimalist approach towards the euro, the currency's future will never be guaranteed.

MISERABLY EQUAL ONCE

Yanis Varoufakis was finance minister of Greece for six months in 2015 during the "worst clashes" of the euro crisis between Athens and Berlin. Varoufakis recalls a German official tried to dissuade him from insisting on debt relief for Greece by mounting an argument that Germany is rich because, the official said, the "majority of its people are poor". "On this last point, he was right," says Varoufakis.

Two reasons have boosted inequality in Germany since the 1990s but more in regards to the distribution of wealth than the distribution of income. Germany's government estimates the Gini coefficient that tracks income inequality has risen from 0.26 in the 1990s to 0.29, not a massive change but the direction is clear. The major concern is the coefficient of wealth stands at 0.74, which means that the wealthiest 10% of the population own 50% of the wealth. The OECD estimates the richest 10% of Germans own 60% compared with an OECD average of 52%.

Much of the rise in German inequality traces to the fall of East Germany in 1989. The only successful revolution in German history meant a country of little inequality, albeit impoverished, adopted the capitalist system whose dynamism boosts inequality. In East Germany, everyone had a place to live, even if divorced couples were forced to stay together and married couples were stuck with in-laws. The concept of unemployment did not exist, even for those the Stasi blacklisted for work. Now the homeless roam the streets and the jobless rate always exceeds that of the former West Germany. On one view, East Germans have traded surveillance and hardship for freedom and a higher standard of living that is unequally shared.

The other drivers of rising German inequality were the economic and labour reforms of the 2000s named after Peter Hartz, who headed a committee seeking to reform the labour market. Policymakers sought remedies for Germany's economy after the absorption of East Germany in 1990 and a strong Deutsche mark sapped Germany's competitiveness so much the country became known in the 2000s as the 'sick man of Europe'. To revive the economy, trade unions agreed for wages to lag productivity. Berlin pushed people on welfare into work, widened powers to retrench staff and encouraged exports. From 1999, a euro weaker than the defunct Deutsche mark, industry outsourcing to eastern Europe and Chinese demand for German capital goods fuelled such an economic revival it was labelled the second Wirtschaftswunder or miracle (the post-war recovery being the first). But forcing millions of people into insecure and unskilled work while millions of others were being enriched by globalisation reshaped German politics and proved a recipe for inequality and the associated political resentment that leaves those left behind prone to populism.

As populists in the UK forged resentment into a campaign to quit the EU, populists in Germany have manipulated the anger of their compatriots against the euro and the ECB. Much of the population is thus against the idea of constantly 'squandering' treasure on citizens of other eurozone countries that they think misspend their way to misfortune. Some of the resentment comes from how budget discipline is mandatory under Germany's social market economic model (Sozialmarktwirtschaft), an anti-Keynesian stance known as the 'debt break' that was suspended until 2022 to fight the covid-19-induced recession.

The EU's recently authorised fiscal stimulus that was hailed as Europe's mini-step towards a fiscal union has only added to anti-EU sentiment. One measure of this is that the biggest opposition party in Germany is the Alternative for Germany party, which was formed in 2013 to pull Germany off the euro (in an orderly fashion) and now reaches into every state parliament and the European parliament.

TOO LOOSE

Sabine Lautenschläger's sudden resignation in 2019 only five years into her eight-year term as Germany's representative on the ECB's board was accompanied by a two-paragraph statement from the central bank that included a thank you from Draghi for her "unwavering commitment to Europe". Lautenschläger might well be a europhile but her departure was regarded as the latest German protest against the ECB's loose monetary policy. She quit one month after the ECB reduced its key rate to a record low of minus 0.5% and resumed quantitative easing after a nine-month break.

Lautenschläger's departure followed the resignations in 2011 of Jürgen Stark as ECB chief economist and Axel Weber as head of the Bundesbank (and thus an ECB board member) over the ECB's lax monetary stance. In the eyes of the German public and tabloid media, the ECB's loose monetary settings have wiped out returns on German savings and are better seen as a German subsidy for lazy southern Europeans. Populists are adept at exploiting their fury. Finance Minister Wolfgang Schäuble in 2016 said, "ultra-low interest rate policies are 50% responsible for the rise of the Alternative for Germany party".

The ECB is bound to stir more controversy in coming years in Germany whose current-account surpluses mean excess savings are generally deposited in banks with business models vulnerable to negative interest rates. A looming flashpoint is that the ECB's

asset-buying, which will see the central bank buy the majority of eurozone government debt sold through 2021 and into 2022, is poised to reach proscribed limits on holding sovereign debt. The ECB said in 2020 it would buy only up to 33% of a nation's public debt under its asset-purchase program but that was up from 25% when the asset purchases started in 2015. Another increase in the percentage is bound to be provocative in Germany.

While the ECB has said it won't buy bonds directly from governments, German taxpayers see the ECB's bond buying as nothing more than their money staving off default in insolvent and badly run southern states that, due to the ECB's action, can avoid the reforms needed to revive their economies. They see such debt monetisation as risking the hyperinflation that savaged Germany twice last century – in the early 1920s and post-1945. Such a view manifested itself in May when Germany's highest court ruled against the ECB's purchases of government debt, the salvation for indebted national governments during the health and associated economic crisis. The Federal Constitutional Court ruled that unless the ECB conducts a "proportional" assessment of its bond-buying to the court's satisfaction the Bundesbank could not participate in the bond buying and must sell past holdings because the German government or parliament had not approved such spending. This ruling clashed with one by Europe's highest court in 2018 when, on ruling on German protests, the European Court of Justice ruled the ECB's bond buying legal.

The way the ECB asset buying works is that national central banks buy their government's debts on behalf of the ECB. That leads to another source of trouble. People in beneficiary countries such as Italy – including a senior aide to caretaker prime minister Giuseppe Conte – are calling for their national central bank to cancel the government's debts to restore solvency. In this simplistic view, one arm of a government (the central bank) owes money to another arm (the treasury), so the debt can be cancelled or swapped for perpetual (never repaid) bonds. In reality, only creative accounting could prevent the treasury being forced to recapitalise the central bank to the amount of the debt cancelled. While no one expects a national central bank to forgive its treasury's debt, such calls intensify political angst in Germany about the ECB and the euro. Thus, keep in mind either of the comments attributed to Merkel in that 2008 emergency meeting next time the eurozone is engulfed in crisis.

By Michael Collins, Investment Specialist

The last thing Europe needs. The euro hits an all-time high

Graph found at ecb.europa.eu/stats/balance_of_payments_and_external/eer/html/index.en.html

Source: ECB

[1] Adam Tooze. 'Crashed. How a decade of financial crises changed the world.' Viking 2018. Penguin Books paperback edition 2019. Pages 184 to 188.

[2] The German side says Merkel quoted in German from Goethe 'Everyone should sweep in front of his door and every city quarter would be clean,' Tooze. Op cit. Page 188.

[3] Merkel deferred attaching rule-of-law conditionality to this and other EU budget money after veto threats from Hungary and Poland, the targets of the condition. See George Soros. 'The cost of Merkel's surrender to Hungarian and Polish extortion.' Project Syndicate. 10 December 2020. project-syndicate.org/commentary/merkel-surrenders-europe-to-hungary-poland-extortion-by-george-soros-2020-12

[4] Eurostat. 'Government debt up to 97.3% of GDP in euro area.' 21 January 2020. Pointing to where the next crisis might emanate, the debt-to-output ratios of Greece, France, Italy, where the 66th post-war government just fell, and Spain stood at 200%, 117%, 154% and 110% respectively on June 30.ec.europa.eu/eurostat/documents/portlet_file_entry/2995521/2-21012021-AP-EN.pdf/a3748b22-e96e-7f62-ba05-11c7192e32f3

[5] Other exchange-rate regimes contain mechanisms to resolve imbalances. Under flexible currency regimes, currencies depreciate. Under pegged regimes, currencies can be devalued. Under the fixed regime of the gold standard, gold transfers initiate the process to correct imbalances. Under the fixed regime of the euro, policymakers must look to other tools such as microeconomic reforms to resolve imbalances.

[6] European Central Bank. 'Daily nominal effective exchange rate of the euro.' ecb.europa.eu/stats/balance_of_payments_and_external/eer/html/index.en.html

[7] Yanis Varoufakis. 'Solidarity with Germans.' Project Syndicate. 3 August 2020. project-syndicate.org/commentary/next-generation-eu-recipe-for-divisiveness-paralysis-by-yanis-varoufakis-2020-08

[8] Germany Ministry of Finance. 'Social inequality and inclusive growth.; 7 June 2019. The ministry sources the figure to the OECD. A Gini coefficient reading of 0 means perfect equality while 1 means perfect inequality. bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/International_affairs/Articles/2019-06-07-social-inequalitiy-and-inclusive-growth.html

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[10] For a view on life in East Germany, see 'Stasiland' by Anna Funder. Swann House. 2002

[11] The immediate political legacy of the Hartz reforms was that it prompted the left wing of the SPD to peel off and link with former East German communists to form Die Linke that, while still a political force in Germany as part of an unruly centre-left coalition, handed the political initiative to Merkel's Christian Democrats. Tooze. Op cit. Pages 94 to 96

[12] European Central Bank release. 'Sabine Lautenschläger resigns from ECB board.' 25 September 2019. ecb.europa.eu/press/pr/date/2019/html/ecb.pr190925~b744158aaa.en.html.

[13] See Financial Times. ''German problem' at ECB exposed by Lautenschläger departure.' 26 September 2019. ft.com/content/704240ec-e04a-11e9-b112-9624ec9edc59

[14] Telegraph. "Europe doesn't work for Germany either, as Schäuble faux pas demonstrates." 26 April 2016. telegraph.co.uk/business/2016/04/26/europe-doesnt-work-for-germany-either-as-schubles-faux-pas-demon/

[15] European Central Bank. 'Public sector purchase program (PSPP) questions and answers.' 30 October 2020. ecb.europa.eu/mopo/implement/app/html/pspp-qa.en.html

[16] Reuters. 'German court ruling ties ECB hands – now and in the future.' 5 May 2020. reuters.com/article/us-ecb-policy-germany-analysis-idUSKBN22H1SH

[17] Financial Times. 'Soaring eurozone government debt reignites call for cancellation.' 8 December 2020. ft.com/content/0295ccb3-bc57-415c-89f7-5d4e63a64c88

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