EUROPEAN OBSERVER / FEATURE - There was a cheeky cartoon that made the Facebook and Twitter rounds a few days ago, posted by one of the Financial Times’ Alphaville bloggers. It went ‘viral’, as the social-media consultants think the kids say. Bearing the title “Introducing Greater Germany,” it featured a map of Europe with all the German bits coloured blue.

The entire eurozone was blue.

If you passed over the map with your mouse, a caption popped up: “The area formerly known as the eurozone.”

Perhaps the author was taking a light jab at the good doctor of Berlin’s diagnosis and her decidedly uncomfortable austerity enemas prescribed to the entire euro area, or suggesting that through the EU’s bundesbank-inspired economic strictures, Germany, finally, in its third try at it, had managed to rule most of Europe. But with the euro area teetering on the edge of the precipice, the joke’s gallows humour and scintilla of Germanophobia was a bit too much for the commenter that took the nom de plume of ‘Former FT Fan’, who humptily wrote underneath the Alphaville blog posting: “Unfortunate bigotry from such a respectable publication,” and also for commenter ‘fjmeid’, who typed: “If that’s supposed to be funny, It’s not.”

These presumably Teutonic commenters lived up to their normally-entirely-unfair po-faced reputation of being unable to fathom British wisecracks, but it might have been commenter ‘Ando’ who came actually closest to comprehending the dilemma facing Europe that on a more serious level underlies the FT’s visual gag when he wrote simply: “Federalism or bust. Which has been the point all along.”

In the early days of the construction of the single currency, it was clear that while monetary union might have been politically saleable, any fiscal or certainly political union were not yet remotely anywhere near even approaching the horizon.

But it is also well known that a number of prominent Europeans at the time went on to say that nevertheless, the one will inevitably lead to the others, that the first serious crisis would perforce immediately precipitate deeper integration, because monetary union amongst a group of states with wildly varying economies is not possible without its more tangibly sovereignty-associated twins.

“Any split in real economic trends would, naturally, exert pressure in the direction of a transfer and social union, or even of a European ‘super-state’,” the then president of the German Bundesbank, Hans Tietmeyer, (famously amongst euro-sceptics) told a group of Danish executives in 1997. Some eurosceptics argue that the federalists were secretly, knowingly setting a trap, that they were very much conscious of the fact that a crisis such as we are facing today would eventually materialise, compelling a more homogenous, cohesive European structure.

But this is undeserved. If there were any who did really think along these lines, they were vastly outnumbered by those - many federalist ultras among them - who ridiculed the idea that such an event would ever come to pass. Professor Tietmeyer himself actually went on
to say in the same speech of the eventuality of a super-state: “You in Denmark - if I understand it correctly - do not want [it], and ... we in Germany - I can assure you - do not want [it] either.”

Indeed, in possibly his most retrospectively cringe-worthy statement, as late as February, 2009, European Commission President Jose Manuel Barroso said, and there is no reason to think he did not truly believe this: “The euro is a protection shield against the crisis.”

There is, as always, the traditional European option of just ‘muddling through’, a strategy that the bloc has always excelled at on an Olympian level, and which many still think is the most likely response to the current crisis. They say austerity may be painful and that it will certainly provoke unexpected and undesirable consequences, but that a rough equilibrium will eventually return and things will then go on much as they have done.

But there are others who remind that this crisis is not like others, that the scale of the debts involved are gargantuan and beyond the ability of current structures to deal with. Muddling through is no longer an option. For them, there are really just two alternatives.

It is no exaggeration to ask whether we are living in the last days of the eurozone, or the first days of a United States of Europe.

Dr Merkel’s fiscal enema

David Marsh is no Basil-Fawlty perfidious germanophobe. A banker with the London and Oxford Markets Capital investment firm, he also worked for ten years in a German consultancy and specialises in British-German business partnerships. He is even a founder of the German-British Forum and a German Order of Merit laureate, awarded for service to Anglo-German relations.

He is also no eurosceptic seig-heiling Ukip MEP or arch-Keynesian euro-worrier. On the whole, he favours the idea, arguing that the single currency “has brought, and will continue to bring substantial benefits - economic, political and social - to people and states.”

Yet even for him, as he writes in his magisterial history of the euro, published in 2009 - two years into the economic crisis, he is worried that the euro has created perils that endanger the very existence of the European Union: “Emerging divisions threaten the fifty-year-old process of post-Second World War European unification.”

And there is one culprit.

“At the heart of the matter is Germany.”

Throughout the EU one regularly hears from politicians, even prime ministers and presidents - often of the French variety - snide remarks that the crisis was born of an American mother. They contend that everything was carrying along tickety-boo until Lehman Brothers, arguing, like an unmasked villain in Scoobie-Doo, that “they would’ve gotten away with it too if it weren’t for those meddling Yanks.”

They are the child who bawls when the wind blows down his house of cards. Or perhaps, to use a more appropriate analogy, the insurance companies, city planners and national disaster-response co-ordinators whose disaster-waiting-to-happen and mangled reaction
to Hurricane Katrina in New Orleans they blamed on an Act of God rather than their own greed and abandonment of duty.

The catalyst was certainly the global economic crisis, but the shock to the eurozone system could have come from anywhere, even from within the EU. It does not matter ‘who started it’. The fact remains that there were structural imbalances built in from the beginning, that the euro was built on weak foundations.

Fundamentally, Marsh’s argument is that a single monetary policy, with its one-fixed-exchange-rate-fits-all, blue-and-yellow spangly unitard, is perilous for a group of countries at different stages of development.

A lesser-developed economy lashed together in the same exchange rate as one as developed as Germany will inevitably lose out. Its weaker products, with higher-per-unit labour costs, will be massively over-priced. Meanwhile, the products of Germany’s export-oriented economy appear tremendously competitive throughout the EU.

This has two effects: First it undermines development in the periphery by squeezing out their less productive competitors. Second, it allows the core country’s export surplus to soar, which then convinces German policy-makers there is no need to develop domestic demand, which could begin to soak up the exports from the periphery.

Normally, this could be rectified by currency devaluation, of the late drachma, peso, punt or lira, but again, strapped into the single currency, this option is unavailable.

“Ironically, one of the reasons why so much of Europe favoured the single currency plan when Germany was reunified,” he notes, “was to counter Germany’s forecast resurgence. Merging the previously dominant D-Mark with more fragile currencies was forecast to bring a more healthy European equilibrium.”

Subsuming the Deutschmark, he says, into a new European monetary regime, was supposed to be part of tying a once-again powerful Germany - long France’s brooding and understandable anxiety - into the broader European interest.

But it hasn’t quite worked out as planned.

Germany didn’t adopt the euro, Europe adopted the Deutschmark.

‘How do you criticise success?’

Lord Harrison, of the British House of Lords EU Economic Affairs Sub-committee was in Brussels in November to grill a flock of policy-makers and think-tankees about solutions to the crisis, specifically the question of European ‘economic governance’, the phrase endorsed at last December’s European Council, the gathering of Europe’s premiers and presidents.

Over drinks in a European-quarter hotel bar with this reporter, he said that most of his committee’s interviewees, though not all, had concurred that an an imbalance of competitiveness within the eurozone is the heart of the matter. But there seem as many definitions of ‘imbalances in competitiveness’ as there are varieties of Belgian beer.
“What do they all mean by ‘competitiveness’? I’ve heard so many differing opinions about this,” he said.

And however much the economic powerhouse of the union may be the root of the problem, “How exactly do you go about criticising Germany for, well, for being successful?”

“And in any case, who would ever have the courage to tell Germany any of this?”

If one only read sections of the financial press, or Germany’s broadsheet-tabloid, Bild - the biggest-selling newspaper in Europe - or even the commission’s own analysis, one could be forgiven for thinking that the country is a shrewd paragon of economic rectitude, probity, efficiency. The fiscal antipode of Grecian fecklessness.

The EU’s Autumn Economic Forecast issued last week salutes how Germany has “recovered remarkably swiftly and vigorously from the crisis, posting six consecutive quarters of above-potential growth.”

The forecast authors, under the supervision of Marco Buti, the grand poobah of the bloc’s Directorate-General for Economic and Financial Affairs, fall over themselves with praise.

“The value of exports is back to pre-crisis levels. Employment growth has been only temporarily dented by the downturn... Germany had not experienced any domestic housing, asset or credit boom prior to the crisis. Moreover, major structural reforms had been carried out in the 2000s, rendering the German labour market more flexible, improving competitiveness and strengthening the profitability of companies.”

If Mary Poppins, a different era’s icon of sobriety, hadn’t laid claim to the strapline before Berlin, the commission would undoubtedly have declared Germany to be “practically perfect in every way.”

Meanwhile, the prodigal son in this parable, Greece, does not help itself any with its incompetent and corrupt state. The narrative ring true in the heads of many northern Europeans, who recollections of holiday frustrations and baksheesh contrast with experiences of German automotive marvels and litter-free streets.

The way the story has been told feels more than plausible.

However, both accounts depend more on stereotype than reality.

As Costas Lapavitsas, a Greek economist with the University of London, recently pointed out: “The largest economy of the eurozone has been marked by slow growth, poor domestic demand, weak investment, high unemployment and miniscule productivity gains. The only area in which Germany has excelled is exports, where it has chalked up large surpluses.”

Crucially, while pressure on wages have been applied across Europe for years, the situation in Germany has been acute in this regard, as the professor notes, with wages barely rising in real terms for a full 15 years, as the country has been unique in Europe in its ability to discipline its workforce and outsource to an effectively union-free eastern Germany and the cheap labour markets of the former Soviet bloc.
Meanwhile, however messy the Greek state, overspending did not cause the crisis because Greece did not overspend.

If we compare the country’s spending alongside that of other EU states, we find that total government spending as a percentage of GDP is thoroughly average.

According to research from tax and monetary policy specialists Michael Linden and Sabina Dewan of the Center for American Progress, a left-leaning think-tank, even taking into the country’s latterly revealed fibbing about its government accounts, over the last ten years, ‘profligate’ Greece has consistently spent less as a proportion of GDP than the EU as a whole. From 2001 to 2007, the period of the last economic cycle, Athens averaged an annual government spend of 44.6 percent of GDP while the EU taken together forked out 46.6 percent.

Crucially, ‘prudent’ Germany actually disbursed 46.7 percent on average over the same period.

“Greece’s location [is] in the middle of the pack on spending,” they wrote in May at the height of the Greek crisis. How middle-of-the-pack? “Precisely in the centre of all EU countries, with 13 countries spending more, and 13 countries spending less.”

Where Greece is not quite so plain vanilla, though, is in tax collection.

The two researchers go on to point out that in 2009, the country collected only 36.9 percent of GDP in government revenues, compared to an EU total of 43.9 percent. Athens’ anorexic tax collection ranks seventh from the bottom out of the 27 member states, alongside, as it happens, Spain and Ireland. As a Cypriot economist, Stavros Tombazos of the University of Cyprus, has also made clear, Greek taxation on capital is only half that imposed on capital in the eurozone.

Greece doesn’t overspend. It undertaxes.

What the country has never been able to come to grips with is its Sumo-wrestler-sized shadow economy and gargantuan illicit financial flows. The US authors note that reports suggest that as much as a quarter of the country’s GDP comes from its underground economy.

It is true that the Greek government was more expansionary than other peripheral countries such as Ireland and Spain, and the country continues to lavish billions on military expenditure. (In passing, it is noteworthy that EU demands for austerity make no emphasis on drastic cuts to arms spending either in Greece or in Portugal, another state that has a predilection for going shopping in the great Franco-German Weapons-R-Us maxi-mart)

Public deficits did consistently exceed the three-percent eurozone limbo-stick maximum, but, leaving aside purchases of German submarines, this had a positive effect on growth. This is reflected in the composition of debt: In Greece, the ratio between public and private debt is more balanced. In Spain meanwhile, where the government did not rack up such a bill, growth was instead driven largely by the housing bubble.

At the same time, the so-called PIIGS economies, despite their varying fiscal policies and differing debt mix, were still all constrained in terms of public spending by the rigid discipline of the stability and growth pact, whatever the occasional flouting of the rules.
They only saw a massive leap in public debt after the crisis washed up in Europe from American shores. European banks trembled, having speculated on mortgage-backed securities, and EU governments bailed them out, underwriting them to the tune of €4.5 trillion (according to commission estimates), atop a recession in which government revenues declined and expenditures on welfare - the famous European ‘automatic stabilisers’ soared.

What pushed government accounts so far into the red had nothing to do with public sector profligacy but was in fact due to a result of a wholesale transfer of private, speculative debt on the part of banks and developers to the public purse.

Austerity is being imposed now not to pay off spending on social welfare, but to pay back the gambling debts of the bankers.

**The China of Europe**

But how did we get into this mess in the first place?

In the 1990s during the run-up to the single currency and throughout the 2000s, all European countries battened down wage demands and loosened the regulations on companies (or, to use the jargon you often hear on the news without really knowing what it means: ‘They liberalised their labour markets’), but it was Germany that won the mad dash to the bottom. The steroids that Berlin had access to that no one else did to the same extent were the aforementioned discipline of labour enabled by the cheap-as-chalk ex-GDR and the rest of the east.

This drastically heightened Germany’s competitive advantage as labour costs per unit - how much it takes to make a given widget - in the periphery of the eurozone outstripped those in the core. This also freed up more spondoolies for German capital to upgrade its products, making sexy German machines that much sexier.

Now, normally, a country in such a situation is able to devalue their currency, making their widgets comparatively sexy, or at least cheap, once again. But strapped into the strong Deutschmark - sorry, ‘euro’ - this was no longer possible.

The massive gap in competitiveness in turn results in a massive, and as it turned out, permanent, structural current account deficit in the peripheral economies. Essentially, they had to buy a lot more stuff than they could sell. Borrowing money to pay for stuff replaces the money you otherwise get from selling stuff.

You’ve heard about the US trade deficit with China, where they’re importing more stuff than they export? And China’s lending the US the cash to buy the stuff that China makes in an unsustainable, rather unsymbiotic relationship? Yeah? Well, this is roughly the same thing.

Germany, as conservative American economist Irwin Stelzer has put it, is the China of Europe.

Eurozone peripheral households made up for this gap by borrowing on their credit cards and against their houses while companies and banks borrowed using what they have instead of credit cards - access to cheap credit. Household debt in Spain, Greece and
Portugal skyrocketed between 2002 and 2007 at an average annual rate of 5.34 percent, 4.48 percent and 3.1 percent of GDP respectively, while in France the rate was 1.77 percent and in Germany, it actually declined, -0.71 percent.

Just as in the States, where predatory lending to those with poor credit ratings gave great returns to American lenders pretending that these households were triple-A rated, lending by EU core countries - by banks in Germany, France and the UK - to enterprises, banks and households in the EU periphery also let the money roll in to these core European lenders who pretended, now that these southern countries were in the eurozone, that peripheral debtors were as trustworthy as those in Germany. They pretended that they were, in effect, mini-Germanies. In Spain and Ireland, famously, this led to real estate bubbles.

These massive, permanent, structural current-account deficits in the periphery were mirrored by massive, permanent, structural current-account surpluses in Germany.

As with China, German and other core-nation banks lent - indeed became massively overexposed - to Spain, Greece, Portugal, Ireland and Italy - so that these undercompetitive countries could buy stuff from the core.

While the eurozone rescues of Greece and Ireland - and perhaps eventually Portugal and Spain - have been sold as bail-outs of these countries, in effect, they are actually a second bail-out of core European banks.

The austerity being imposed on these nations by the EU-IMF-ECB troika is a wholesale transfer of public wealth into the pockets of EU-core bankers, who, as we are well aware, have continued to pay themselves handsome billion-euro-and-pound bonuses.

Tied into the euro, these countries cannot devalue to regain competitiveness with Germany. The only policy option left to them, or, rather the only policy option left to them by the troika, is what is called ‘internal devaluation’, a.k.a. austerity. By cutting wages and stripping the public sector to the bone, internal demand is sharply reduced. A sort of balance is restored and products become cheaper.

But of course at enormous human cost.

And there is no guarantee that this path will even work. Even if we assume that there is no violent backlash from the populace of the peripheral countries as such draconian measures are enacted - and we so no evidence so far that people are exactly copacetic about all this, given the wave of general strikes, occupations, blockades, boss-nappings, riots and even small-scale terrorism that has accompanied this policy choice - historically, internal devaluation has rarely if ever worked.

Lord Robert Skidelsky, the economic historian, author, baron and one-time member of each of the British Labour, Social Democratic and Conservative Parties, has recently returned to the bestseller shelves with his slim volume explaining the economic crisis to the layman via a Keynesian framework, Keynes: The Return of the Master. He is scathing about the ever-impoverishing strategy chosen by Brussels.

“As a general principle, if you impose austerity on an already weak economy, one that has suffered severe shocks, then you destroy your recovery mechanism as you are decreasing
aggregate demand,” he says. “In Ireland, the government will be taking an extra £5 billion out of the economy, and I don’t see where you get the growth.”

A more likely scenario is that growth in these countries is arrested, pushing them further into debt as they fail to meet interest payments and putting further strain on the eurozone, making default perhaps inevitable.

He worries particularly that the EU will become synonymous with brutal austerity in the minds of its citizens, threatening her very existence.

“It is a huge political gamble to associate the European project with years of austerity. In my view the current path will substantially reduce political support for the single currency, and for the whole European project.”

Cypriot economist Tombazos again: “This [austerity] scenario perpetuates the economic crisis rather than contributes to overcoming it, thus escalating the centrifugal tendencies of the euro.”

“The danger exists that it will lead to the dissolution of the eurozone,” and, echoing Skidelsky’s words precisely, “if not the entire European project.”

**Back to the future with the Werner Plan**

So how do we get out of this mess?

It’s relatively simple, really. All that has to happen is a rebalancing of competitiveness between the core and the periphery.

“Of course much of the responsibility lies with Germany, doesn’t it?” continues Lord Skidelsky. “The euro was constructed in a way that benefited an export-led economy like Germany, but not everyone else. They have repressed wages to create room for exports, which then chokes off growth paths for other eurozone countries, who can’t readily increase their exports to Germany.”

The short version is that Germany must be forced to sharply boost its wages and inject stimulus: “Domestic demand in Germany should be expanded,” he concludes.

But the detail in such a plan however would require that Berlin also re-regulate its labour market, and the stimulus must be on a massive, Chinese scale. Europe would also have to institute substantial, low to zero-cost fiscal transfers from the core to the periphery. This of course would have to be accompanied by the creation of a European Treasury.

“If the euro is to survive, it has to develop a central treasury with a budget of five to 10 percent of GDP capable of dealing with asymmetric shocks, such as they have in federal systems like the USA,” he explains.

“Logically, you will have to start all over again with a better design.”

Overcoming the imbalances would also require the imposition of common eurozone labour law, welfare and move towards tax harmonisation.

Basically nothing less than a United States of Europe!
A piece of cake, or even zuckerkuchen, no?

You’d be surprised.

It’s not just Keynesians and other heterodox economists who recognise that profoundly deeper European integration may be unavoidable. The precocious original attempted architects of a single European currency could not imagine anything less.

As early as 1970, the Werner Plan, Europe’s first proposed architecture for a single currency and drafted by Luxemburg’s then prime minister, Pierre Werner, recognised that economic union had to accompany monetary union and called for a bold advance towards federalism, with the transfer of all fiscal powers - taxation, public spending and borrowing - from national parliaments to the European Commission.

Much more recently, Christine Lagarde, France’s finance minister, has said repeatedly in the last few weeks that further integration is inevitable. Jean-Claude Trichet, head of the European Central Bank on 30 November at a meeting of the European Parliament’s economic and monetary affairs committee called on European states to fuse together their budgetary processes in order to save the euro: "We have got a monetary federation. We need quasi-budget federation as well."

While back in May, European Council President Herman Van Rompuy acknowledged that the underlying contradictions within the eurozone had been there from the start and it was time to resolve them: "We are clearly confronted with a tension within the system, the infamous dilemma of being a monetary union and not a full-fledged economic and political union. This tension has been there since the single currency was created. However, the general public was not really made aware of it."

In 2007, at the start of the crisis, eurogroup chairman and Luxembourghish Prime Minister Jean-Claude Juncker put the public relations dilemma more laconically: "We all know what to do; We just don’t know how to get re-elected once we have done it."

And two weeks ago, Lagarde’s compatriot and chief of the International Monetary Fund, Dominique Strauss-Kahn gave a remarkable, landmark speech putting flesh on the bones of what will have to be done.

“The only answer is more co-operation, and greater integration,” he told a conference of the European Banking Congress in Frankfurt. “It’s time to finish the job, to finally realise the common destiny of Europe.”

This will, according to the IMF boss, full “economic union”, with “Single Labor Market” initiative at the European level, the “sequel to the Single Market [Act] that harmonised goods markets,” that was completed in 1992. This would involve, he said, common European labour taxation, common welfare systems, and common unemployment insurance. National secondary education and research budgets should also be transferred to the EU, and Europe’s budget as a whole substantially increased, currently strictly limited by the EU Treaties, via European-level taxation, whether coming from VAT or carbon taxes, he concluded.

What Strauss-Kahn crucially left out was that naturally this couldn’t be done on the back of the current EU political set-up with its infamous democratic deficit. Even if we imagined
that there existed amongst voters a substantial constituency for such a wrenching abandonment of the fiscal powers that are, apart from foreign policy, the defining features of any sovereign state, there would have to be much more democratic accountability for all this economic union, so it would have to be accompanied by political union too.

But as Costas Lapavitsas, the University of London economist and critic of the austerity strategy we met earlier, points out, this is not the sort of integration the likes of Strauss-Kahn, Van Rompuy, Lagarde, and Juncker have in mind.

“I’m sceptical that they have the democratic impulse for what this sort of integration implies. We are talking about the same sort of people who could not accept the popular rejection of the [European] Constitutional Treaty in France and the Netherlands in 2005, who could not accept the rejection of the Lisbon Treaty by the Irish [in 2008].”

While the ECB may be talking about deeper integration, it is quite clear from a revealing RTE interview with the Irish justice minister, Dermot Ahern on 30 November, the famously independent central bank, itself quite used to being aloof from political influence, exhibits few scruples when it comes to the democratic process.

Ahern told the Irish public broadcaster that “quite incredible pressure” had been applied to the country to apply for a eurozone bail-out.

“There were people from outside this country who were trying to bounce us in, as a sovereign state, into making an application - throwing in the towel - before we had even considered it as a government,” he said.

“If you notice they are doing the same with Portugal.” Asked who these people “from outside this country” were, he bluntly responded that they were "quite obviously" the men from the ECB.

This distaste for democratic oversight is implicit in Strauss-Kahn’s thinking. If we read the whole of his speech, going beyond the head-line-grabbing calls for common EU labour policy, education policy and taxation, we discover more of thinking and behaviour along these lines.

The kind of federalism the IMF chief imagines - although he doesn’t call it federalism, preferring the term “a ‘Centre-Driven Agenda’,” would extinguish all direct democratic control over government spending.

“The most ambitious solution,” he says, “would be to create a centralised fiscal authority, with political independence comparable to that of the ECB. The authority would set each member’s fiscal stance and allocate resources from the central budget.”

In less fancy language, he is saying that a central, unelected body - just like the European Central Bank, although Strauss-Kahn says this Star-Chamber role could be played by the commission or “a separate, independent institution” - would decide exactly how much a country could spend on what and then hand out an allowance to a country, like the spending money a parent gives to a child, presumably so long as it behaves, eats all its vegetables and cleans up its room.

But even if there were the political will and popular support for a quantum leap forward in terms of any form of European federal integration, à la the IMF or a more democratic
version, Lord Skidelsky fears “that the markets will call the shots long before this happens.”

Markets are running faster than history. “Events are outpacing politicians.”

**The end of the eurozone**

But if what needs to happen cannot happen, what does Lord Skidelsky, a 71-year-old economic historian who has been witness to the full fifty years of European integration, think will?

“I don’t think immediately, but the most likely outcome is that some countries will have to devalue, which means leaving the eurozone. Germany’s domestic policy doesn’t allow any other option.”

“What I don’t know is whether the initial thrust for this will come from a Germany where people are fed up with bail-outs or from the peripheral states where people are fed up with continuous austerity.”

Not that he thinks the eurozone will disintegrate entirely, but rather splinter, into two euros: perhaps between the core - Germany along with other surplus member states such as the Netherlands, Austria and perhaps Finland - on the one hand and the periphery on the other. Although it is an open and important question as to which side the others in the eurozone, France, Belgium and the rest, will fall.

Lapavitsas is of a similar mind: “Ireland must come to the realisation that being in the Eurozone with its current structure is a trap. It offers no option to the country other than austerity.”

“The response must be radical, in both Greece and Ireland, and probably the rest of the periphery of the Eurozone. They simply cannot handle the present scale of their debts and must default.”

However, going further than Skidelsky, he hopes that the break will come from within the peripheral states themselves rather than being booted out by Germany so that any restructuring or default - and the conditions that are attached - are set by the debtors rather than the creditors. If default is creditor-led, he argues, the required significant reduction of debt would be highly unlikely as creditors would ensure that their losses were as minimal as possible.

Lapavitsas again: “Of course the issue of membership in the euro will be put on the table and will have to be considered. But this might be an opportunity for a profound shift in the direction of economic development away from the disastrous road of the past.”

He notes that in 2001, when Argentina in a similar sovereign debt situation, with its peso pegged to the dollar, decided to suspend payments on its entire $144 billion public debt and abandon the dollar peg, the sky did not fall.

Initially the fall-out was severe: GDP declined by 11 percent in 2002, but the economy rebounded rapidly. From 2003 to 2007, GDP per capita maintained a growth rate of 8-9 percent annually. The bogeyman of being cut off from capital markets also never
materialised. In 2006, when international debt markets to the country were re-opened, Argentina sold $500 million worth of bonds.

In 1999 in a similar situation, Russia defaulted on its external debts with an accompanying rapid devaluation of the rouble, but here it took only months for the economy to return to growth.

More recently and closer to home, in 2008, Iceland’s devaluation was as violent as the eruption of Eyjafjallajökull, and yet the country is now returning to growth once more.

The Greek economist does not counsel this option lightly, saying that there would be “serious implications” for such a policy shift: for a period, economic output would likely decline and unemployment would rise. Additionally, those with home mortgages taken out from foreign banks would see their personal debt levels skyrocket. There would have to be supplemental measures introduced to protect these households.

As a result of all of these dangers, “It is essential to have a frank public debate” over the costs and benefits of the move. Citizens would have to be the ones that consciously chose this path, fully informed and cognizant of the difficult days that lay ahead. Default could not be imposed from on high by fiat.

Such a shock to the EU system, he reckons, might anyway even jolt everyone into realising that the ‘good euro’ option, the radical leap toward a federal system that benefitted all member states, is necessary.

There are some additional concerns however, as the case of the European periphery, is not identical to that of Argentina, Russia or Iceland.

Argentina’s peso actually physically existed. The peso was only pegged to the dollar. But the drachma does no longer. So the costs of re-introducing these currencies as well as new software and cash machines, let alone producing new notes and coins, would be substantial.

And all of this only works if you are the only one devaluing. If everyone else does too, it doesn’t work. If the entire periphery spun off with its own ‘Mediterranean euro’, or worse yet, they each devalued independently, would this create a fresh European crisis of competitive devaluations? This was one of the problems the euro was created to solve.

Deutchmark Mark II

Whisper it, whisper it, but there are a number of economists in Berlin and Frankfurt who also believe that splintering the euro might not be such a bad option. However, for them, it is better that it not be Greece or Ireland that leaves the single currency first, but Germany.

There are two main ways the euro could splinter. But the crucial thing to understand is that Germany leaving the euro and re-adopting the deutchmark while the periphery stays in the euro is not the mirror image of the periphery leaving the euro and Germany staying inside. These two may seem to be opposite sides of the same coin, but they are not.

Turning the clock back again, when it was being decided who would qualify for EMU - economic and monetary union - Germany had originally favoured a euro composed of just northern economies. Paris, with its looser approach to budget deficits, worried this would
put Berlin in the driver’s seat and so ensured that the southern states would be able to join, easing the pressure on itself.

The economists that favour a return of the deutschmark - or a ‘deutsch-euro’, if Austria, Finland and the Netherlands go off in a huff with the leader of the pack as well - are nostalgic for this never-was arrangement. Instituted today, it would see the ‘D-Mark Mark II’ sharply appreciate. Inflation risks would decline and the ‘solidarity duty’ to transfer funds southward would dissolve. Germany’s own euro-denominated debt - and Germany is pretty indebted itself - would become easy to dispose of, producing a windfall for both government and enterprise.

“And there would be other compensations: pensioners could retire to Spain and live like kings,” as financier George Soros has pithily noted about this option.

But the drawbacks outweigh the advantages, as Soros, who does not at all favour a return of the deutschmark, points out. Germans would quickly feel what it is like to be stuck with an overvalued currency and its accompanying rise in unemployment. The D-Mark Mark II boosters however counter that this is not a foregone conclusion, as demand for quality German machinery is pretty inelastic (minus the jargon: a change in price has little effect on how much of the stuff folks want to buy), eastern labour would become even cheaper and euro-priced assets would become as cheap as an empty shoe box.

The periphery would benefit as well, although only in a highly limited fashion. If they collectively stayed in the euro while Berlin left, the cost of paying back the euro-denominated debt they owed to Germany would be moderately reduced as the reborn D-Mark climbed. At the same time, the debt does not disappear, so the periphery remains handicapped.

But if it is Germany that stays in the euro and the periphery that exits, either individually or collectively, then the cost to the periphery of its euro-denominated debt does the opposite: it soars, which is why euro exit absolutely must be twinned with default for the periphery to benefit.

The German government will try to prevent this option - exit and default - at all costs because this would entail massive losses for its banks, losses that would then require massive injections of public cash, a la Ireland, turning Europe’s economic powerhouse into its own sovereign debt basket-case as private debt is again transferred to public accounts.

And the main purpose of this entire exercise is to save the big banks of the core of Europe.

In any case, we cannot ignore the political ramifications of either option. Both moves would inevitably kill the single market, and what is the EU without its single market?

As Soros puts it: “It is extremely unlikely that Germany would be allowed to leave the euro and to do so in a friendly manner. Germany’s exit would be destabilising financially, economically, and above all politically. The collapse of the single market would be difficult to avoid.”

The political destabilisation would be profound, not least because there are countries between core and periphery, most notably France.

The Franco-German partnership would instantly be over.
France’s economic interests have long diverged sharply from those of Germany. Unable to bridle its workforce in the way that Germany can, Paris requires a looser monetary and fiscal policy. This is both for structural reasons - it has no eastern fringe that can be used as a disciplining force (German boss to German workers: ‘Lads, if you don’t back off on your demands, I might just have to move the factory to Bratislava!’); and for domestic political reasons - the country’s unextinguishable labour militancy (French boss to French workers: ‘Lads, all right, all right! Stop boss-napping me and tying me up in the canteen toilet and I’ll give you your raise.’)

This divergence has always been a problem, but a politically manageable one. But now, if you take the PIIGS out of the eurozone, it is France that then begins to look fairly porcine compared to Germany and friends.

“There any splintering of the eurozone may well put France in the position of a peripheral state in a shrunken German-dominated eurozone,” Skidelsky reminds.

But it is the politics of such an option that are far more important.

The origins, the very purpose, the beating heart of the European project has always been to tie eternally warring France and Germany together.

France economically cannot ride off into the sunset with Germany and a new deutschmark, but politically, it it is even more unthinkable for her to leave and make common cause in any peripheral union.

“France has no choice but to stick to Germany. They will hope to influence and modify the German position, but Germany is the most important country. There is no way France could join some sort of PIIGS union if these countries splinter off. For France, it is essential that it preserve its place in the core; it can’t conceive of another position outside the core of Europe.”

But the imbalance that exists between the core and the periphery would then simply be replaced by an imbalance between the two most important European states. France would become the new Greece. The core of Europe would become EU utterly unstable.

**Germany’s choice**

The euro is not just a part of the European project anymore, that can be calmly taken apart to be put back together again at some more propitious moment: the euro has woven itself into the fabric of the EU. If there is no eurozone, there is no EU.

It’s Germany’s choice: either a splintering of the eurozone and the end of the European Union - or a United States of Europe.

As a coda, to be very clear, this essay is not intended as the ‘anti-Bild’, or to replicate any of the dark insinuations that some inferred from the Financial Times’ cartoon-map.

German working families too have not benefited as their wages have been kept down these last 15 years, and a return of the deutschmark would only see them pressed down further as the disparity between German wages, paid in superhuman currency, and eastern wages, paid in something else, grew ever more stark.
Germany has been as masochistic to its own population as it has been sadistic to those outside its borders.

We’re all - Germans and Greeks and Irish and French and the rest alike - working the night-shift in the German austerity sweatshop.