A Storm Is Brewing Over Europe

Geopolitical Weekly
FEBRUARY 14, 2017 | 08:00 GMT

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Storm clouds are once again gathering above the eurozone. In coming months, its continuity will be threatened by events in Europe and the United States. Germany, the largest political and economic player in Europe, will try to keep the bloc together. But the crisis could be too big for Berlin to handle, especially since some of the actors involved see Germany as a part of the problem rather than the solution.

U.S. President Donald Trump recently described the European Union as "a vehicle for Germany." He and members of his administration argue that Germany's industry has benefited significantly since the introduction of the euro in the early 2000s. The boon to Germany, the argument goes, is that the common European currency is weaker than the deutsche mark would be; the result is more competitive German exports. Trump was not the first U.S. president to criticize Germany's trade surplus, the biggest in the world. But he was the first to suggest the United States could take countermeasures against German exports.

Some of Germany's own eurozone partners have also accused the country of exporting too much and importing too little, a situation that leads to low unemployment in Germany and to high unemployment elsewhere in the currency area. Their charges, however, do not focus on the value of the euro (which is set by the European Central Bank) but on Berlin's tight fiscal policies, which restrict domestic consumption and limit Germans' appetite for imports. The European Commission and the International Monetary Fund have asked Germany to increase investment in public infrastructure and raise the wages of German workers.
Addressing the German Question

Indeed, the European Union is a vehicle for Germany, but for reasons that go well beyond trade. Many of Europe’s current political and economic structures were designed to resolve the question of Germany’s role in Europe. Situated at the center of the North European Plain, the largest mountain-free territory in Europe, Germany has no clear borders. This means that its neighbors in the east and the west can easily invade, a fact that has traditionally given German leaders a sense of constant insecurity. In addition, before the country’s unification in the 1870s, the Germans had little in common other than language. Their location at the heart of trade routes in Central Europe and their access to many navigable rivers allowed the Germans to develop multiple economic centers. The Holy Roman Empire, which ruled over German lands, lasted for 10 centuries precisely because the emperor had limited influence on the affairs of the hundreds of political entities that made up the empire. Seeing a strong, united Germany in the 21st century makes it easier to forget that the country has traditionally had strong regional identities and powerful centrifugal tendencies that worked against national unity.

Germany’s Geographic Challenge

Between the mid-19th and the mid-20th centuries, German leaders sought to solve the country’s geopolitical challenges through war, with disastrous consequences for Germany and for the rest of Europe. After World War II, Germany built a federal system where wealth is distributed between states, under the supervision of the federal government. This was
coupled with a corporatist economic model that incorporates the economic elites into the leadership structure and strong social safety nets that prevent social upheaval. This entire social-political structure relies on an economic model that is heavily dependent on exports.

To a large extent, the European institutions were imposed on Germany. A weak and occupied West Germany saw membership in the European Economic Community (the European Union's predecessor) as a way to peacefully return to the international community after two world wars. The political and economic integration of Western Europe was actually a French idea encouraged by a great deal of U.S. pressure. After Germany’s reunification in 1990, the creation of the eurozone followed a similar pattern. Paris saw the introduction of a common currency as a way to bind France and Germany so close together that another war between them would be impossible. At the time, the idea of another Franco-German war did not seem as far-fetched as it does now, and to a large extent losing the deutsche mark was the price that Germany had to pay for reunification.

Solving Problems and Creating New Ones

Europe's economic and political integration enabled Germany to achieve some of its main geopolitical goals. It reduced the likelihood of another war on the North European Plain by creating a co-leadership of the Continent with France. Even after the French economy started to show signs of decay, Berlin made sure to keep Paris involved in continental decision-making. European integration also opened markets from Portugal to Romania, and from Finland to Cyprus, for German exports. All of this was possible while Germany's membership in NATO kept Berlin's defense expenditures modest.

But the euro's arrival deprived some of Germany's main trade partners of the ability to devalue their currencies to compete against their neighbor in the north. At the time the bargain seemed fair, since countries in Mediterranean Europe were suddenly able to issue debt at Northern European interest rates, which they did enthusiastically. Access to cheap debt made many countries in the eurozone delay the introduction of structural reforms in their increasingly less competitive economies.

The euro may not have been a German idea, but Berlin made sure that it did not threaten its interests. The European Central Bank was modeled after the Bundesbank, with its mission of low inflation (a German obsession after the hyperinflationary 1930s) and with no explicit mandate to foster economic growth. The eurozone was created as a monetary union without a fiscal union. No mechanisms to transfer resources from Europe's wealthy north to its relatively poorer south, or to share risk among their financial sectors, were introduced. To accept greater risk sharing, countries in the north require their southern partners to completely surrender their fiscal policies to technocrats in Brussels. This is something that countries like Greece could be pressured to accept but that is unacceptable for countries such as France or Italy.

A Perfect Storm in the Making
These shortcomings became apparent during the past decade. Europe's economic crisis, and the austerity measures that followed it, led to the emergence of nationalist, populist and anti-establishment political forces across the Continent. Some are critical of the European Union, while others want to get rid of the eurozone. The economic decline of France and Italy left Germany without reliable partners to redesign either one of them.

Every year of the past decade has been a test of the eurozone's resilience, but 2017 could be the year when the bloc's very survival is endangered. France will hold presidential elections in two rounds in April and May. Opinion polls say the National Front party, which has promised to hold a referendum on France's membership in the eurozone, should win the first round but be defeated in the second. The Brexit referendum and the U.S. presidential election, however, have shown that polls sometimes fail to detect the deep social tendencies driving populist movements.

Moreover, a recent scandal involving France's main conservative presidential candidate, Francois Fillon, has damaged his image. Should the center-right fail to reach the second round of the elections, millions of conservative votes will be up for grabs. Some would probably migrate to centrist parties, attracted by their promise of economic reform. But many would go to the far right, seduced by proposals to increase security, impose tougher rules on immigration and restore France's national sovereignty. A win by the far-right candidate — a direct threat to the eurozone's survival — cannot be ruled out.
In Italy, things are even more complex, as two of the three most popular political parties want to leave the eurozone. Italian lawmakers are using the need to reform the country's electoral law as a pretext to delay elections. But even if Parliament ends its mandate in early 2018, Italy's threat to the eurozone will be delayed rather than averted. Unlike France, where the two-round electoral system was designed to prevent extremist parties from reaching power, Italy's proportional system means that Euroskeptic forces stand a real chance of entering the government. And no matter the outcome of the election, Italy's massive public debt (which, at roughly 130 percent of GDP, is the second-highest ratio in the eurozone after Greece) will remain a ticking bomb for the currency area.

The mere announcement of a referendum on eurozone membership in France or Italy could be enough to precipitate the collapse of the currency area. A run on Southern European banks could happen before the referendum even took place if people feared that their savings could be converted into national currencies. People in countries such as Italy, Spain or Portugal could transfer their savings to havens in Northern Europe, hoping to be given German marks instead of Italian lira, Spanish pesetas or Portuguese escudos.

To make things more complicated, the Greek saga is not over. Greece's creditors are debating whether the terms of the bailout program are realistic and whether Athens should be granted debt relief. Ten years into the Greek crisis and three international rescue programs later, Athens remains a danger for the eurozone. The main concern is not Greece's debt per se, because most of Athens' debt is in the hands of institutional creditors such as the IMF, the ECB and the European Union's bailout funds, which means that a Greek default can be contained. The problem is that a Greek exit from the eurozone could lead to a contagion effect that could hurt the likes of Italy, Spain or Portugal. Some have argued that the eurozone would actually be stronger without Greece in it, but the price of finding out whether that's true could be too high.

Should France or Italy be taken over by Euroskeptic forces, or should Greece precipitate yet another crisis in the eurozone, Germany's instinctive reaction would be to seek accommodation with its partners in the currency area to protect the status quo. But depending on the magnitude of the crisis, officials in Berlin could be forced to make preparations for a post-eurozone world. This could involve returning to the deutsche mark or, as some German economists have proposed, creating some kind of "northern eurozone" with the likes of Austria and the Netherlands. But a strategy that makes sense from a financial point of view could be risky from a geopolitical perspective, since any moves to distance Germany from France hide the germ of a future conflict between the two. No matter what Berlin does, it has to ensure that political ties with Paris remain as strong as possible. Germany holds general elections in September, and events in the previous six months would have a direct impact on the electoral strategies of the main political parties.

**A Fragile Eurozone**

The threats to the eurozone would be easier for Germany to tolerate if things were quiet in the United States. But Trump's protectionist rhetoric is encouraging nationalist forces in
Europe. France's National Front leader, Marine Le Pen, has even bragged that the U.S. president is actually copying proposals she made five years ago.

The coming storm in the eurozone does not necessarily have to destroy it. The U.S. government could decide to avoid a trade war with its allies in Europe. Moderate forces could win the general elections in France and Italy, and Greece and its creditors could find yet another last-minute agreement. But the fact that the eurozone has reached a point where the entire system can collapse because of an election, a bailout negotiation or measures taken by a foreign government speaks volumes of its fragility.

Even if the doomsday scenario is averted in 2017, the relief may last only until the next election. In Europe, as in the United States, there are millions of voters who feel that the alleged benefits of globalization have not reached them, and who believe that their economic problems could be solved by putting an end to the free movement of people, goods and services — the very principles upon which European integration was built.

The rhetoric from the U.S. government and the rise of nationalist forces in Europe pose a fundamental threat for an export-dependent economy like Germany's. They also threaten the continuity not only of the eurozone but, depending on how events unfold, also of many of the political and economic strictures that Europe built after the war. The supranational eurozone is a half-built house in a neighborhood where national sovereignty has been eroded but not completely erased. The irreconcilability of this dilemma could take the currency bloc from its current fragmentation to outright dissolution.