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Columnists

A euro without Germany? Don't bet against it

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If the Bundesbank doesn't get its way on bailouts, the impossible may become inevitable

In financial crises, events can move from impossible to inevitable without ever passing through improbable. This is something I have been repeating since the near-collapse of every leading bank in the world that started with the bankruptcy of Lehman, whose third anniversary is tomorrow. The eye of the hurricane has now moved from America to Europe, but its course is as unpredictable as ever.

Today three outcomes face Europe. One seems inevitable: continuing chaos. One appears improbable, although it must be seriously considered: a break-up of the euro caused by government defaults and bank failures in Greece. And one fantastical scenario is still generally deemed impossible: German withdrawal from the eurozone.

In the coming months or even weeks, however, some probabilities may be abruptly revised. The one calculation that will not change is about the inevitability of chaos. The fundamental contradiction between a single currency and a multiplicity of divergent national economic policies is now universally accepted and financial normality cannot return until it is resolved by turning the eurozone into a much tighter fiscal and political union.

But such a huge leap cannot occur for at least 18 months to two years. Even on the most favourable assumptions about European politics, that is how long it would take to debate, legislate and ratify a treaty that established the necessary institutions — a European finance ministry with veto authority over national tax and spending policies and the legal instruments for issuing jointly guaranteed bonds.

The trouble is that this timetable is inconsistent with any hope of restoring financial stability, at least before the end of 2012. Financial markets work on a timescale of months and weeks, not years, and the difference between the two timetables almost guarantees a continuing series of financial crises. Moreover, the move towards fiscal

federalism remains so controversial that political progress comes to a standstill whenever the mood of financial crisis subsides.

Which brings us to an outcome that remains fairly improbable, but must be taken very seriously. This is, of course, a break-up of the euro after the expulsion of its weakest members, starting with Greece.

If Greece were expelled, a break-up of the single currency would follow an almost inexorable logic. Suppose Greece transformed all its bank balances from euros into drachmas and devalued them by half overnight. The citizens of Portugal, the next weakest country, would immediately anticipate similar losses and shift all their savings into German or Swiss banks. Portuguese banks would have to close their doors and once that happened, even the financial power of the European Central Bank might be insufficient to prevent bank runs spreading to Spain, Italy and France.

At that point, only the promise of the German Government to “do whatever it takes” would stand in the way of a complete break-up of the euro. But what if Germany’s leading politicians and businessmen, currently still united in their pro-European instincts, were challenged by some other equally powerful German institution?

This brings me to the seemingly impossible scenario that could suddenly be inevitable. It may turn out that the key to the euro’s future will be Germany’s voluntary withdrawal. This seemingly fantastical idea could gain credibility for two reasons.

First, a German exit would be much less disruptive than a Greek expulsion, because it would not trigger bank runs in countries remaining within the single currency, all of which would automatically devalue against Germany at the same moment, leaving Portuguese savers with no more incentive to shift their money to Germany than they now have to exchange their euros for Swiss francs, US dollars or Japanese yen. If Germany left, the Netherlands and Austria would certainly follow, but the other countries could remain in a French-led single currency that would be drastically devalued and could be run on less austere Mediterranean principles.

Second, and more importantly, deep splits over the euro have begun to emerge among the German political and financial elites. This mention of elites is deliberate because the German people have always been unhappy about the euro, but popular pressure alone would never be enough to break the integrationist instincts of the main political parties, especially when coupled with the interests of German exporters, for whom the euro has been a boon. In the past few weeks, however, a new power that could overwhelm establishment politicians and business leaders has suddenly appeared —— the country’s most respected and politically independent institution, the Bundesbank.

The most dangerous event of the summer for the euro was not the failure of the Greek austerity programme, the ambivalent judgment of the German Constitutional Court or the defeat of Angela Merkel in recent elections. It was the resignation last Friday of Jürgen Stark, the German appointee to the ECB Council and the former vice-president of the Bundesbank. He walked out after being outvoted over ECB support for Italy and Spain. His protest came after the resignation of Axel Weber, the Bundesbank President, in February for exactly the same reason.

If, as is likely, the ECB soon has to engage in an even bigger support operation for Italy and Spain, Mr Weber's replacement as Bundesbank President, Jens Weidmann, has already suggested that he would vote against. If he were outvoted and also resigned in protest, it would be hard to see how the Bundesbank could continue to be represented on the ECB board. Given the almost religious faith in the Bundesbank, the seemingly impossible — a euro without Germany — could suddenly become inevitable.