

The Merkel Gambit

Written by Andrew J. Gawthorpe

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ANDREW J. GAWTHORPE, DEC 12 2011

It was unfortunate, if depressingly predictable, that the reaction of British media outlets, commentators, and politicians to the decision taken at the recent European summit focused so exclusively on the British government's decision not to become part of the new "fiscal pact" which the other 26 European Union member states now look set to embark upon. Given that the overall financial situation in Europe seems so utterly beyond the control of our politicians, it is tempting to endlessly analyze what decisions they do make, when they finally get around to it. The temporary escape into old themes and old battles, such as that over Europe in Britain, provides a temporary welcome relief for our political and media classes. But the remorseless logic of the financial markets will awake them from their reverie soon enough. For the simple fact is that the new fiscal pact will probably never come into existence, and certainly not in the form proposed.

It is worth briefly recounting what lies at the root of the current problems of European monetary union before we can consider where the summit leaves us. Eurozone members face a sovereign debt crisis in which financial markets have become unwilling to fund their budget deficits due to the belief that the money lent will never be returned. The crisis first affected Greece, which has now defaulted in all but name, but the interconnectedness of the eurozone banking system has meant that the problem has spread and every eurozone member state, including Germany, has seen its creditworthiness eroded.

Two things must be done to solve the crisis. Firstly and most immediately, the short-term funding problems of eurozone nations need to be addressed. Quite simply, money must be found from somewhere to fund the deficits of eurozone countries which the financial markets are no longer willing to fund. This has been the role of the series of progressively-larger bail-out funds that the eurozone nations have created, but they have never been large enough. There have followed calls for the European Central Bank to fund the deficits of those countries unable to borrow. But it is politically impossible and economically unwise for either the bail-out funds or the ECB to pour money into insolvent eurozone nations without any guarantee that they will, in the future, become solvent. And it would be particularly troubling for the ECB to do this as an intervention by it on a scale likely to address the crisis would also risk stoking inflation.

Thus, the second thing which needs to be done to solve the crisis is the provision of guarantees that peripheral eurozone nations will mend their spendthrift ways and not require a blank check from those who must fund them in the short-term – be they German taxpayers who pay into the bail-out fund, or the ECB. Just as the flag followed trade in the establishment of the British Empire, the demand for control over the spending of peripheral eurozone nations follows the provision of credit to fund their short-term deficits. In reality this means a loss of sovereignty over their fiscal policy, and the passage of this power to the powerful northern countries in the eurozone. Only then would it be feasible or wise for the northern European countries or the ECB to provide enough short-term liquidity to stem the tide. Without these guarantees, even if the ECB turns on the taps, it would eventually have to be recapitalized by European taxpayers when the peripheral countries inevitably default.

These are the requirements of any long-term solution to the eurozone's problems – and they are requirements that the agreement for a "fiscal pact" completely fails to meet. In fact, so complete is the mismatch between the requirements of a solution and what the agreement actually achieves, that one misunderstands it by viewing it as even an attempt at a final solution. Absent from the agreement is any mechanism for providing the short-term funds

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that peripheral nations need to fund their deficits, or any credible long-term architecture to discourage them from running deficits in the future. What has been agreed is only a slightly stronger version of the Stability and Growth Pact, which was brushed aside by European leaders – France and Germany at the forefront – when it suited them. Nor would the pact, even if it worked, necessarily prevent future sovereign debt crises – Spain is in a dire predicament now despite never having violated the old Stability and Growth Pact.

The pact, if implemented, would also be savagely deflationary. Northern European politicians need to persuade the southerners to spend their money more wisely so that it is politically feasible for northern taxpayers to fund the South, but in the long run a eurozone in which everyone was as careful with their money as the Germans would not be economically feasible. Thus there is a contradiction in the German policy of attempting to export its austere ways across the continent, because the success of the German economy depends in part on spending on German goods and services by the spendthrift nations of the South. While in the short term a crackdown on deficits is unavoidable, a dirty secret of the pact is that it would need to be violated eventually if Europe were ever to return to growth. This fact does not lend more weight to its credibility.

If navigating the above analysis is enough to give the reader a headache, one can only imagine how sore their heads are in the German chancellery. But it appears that Angela Merkel's strategy of taking incomplete, partial steps at each summit is a response to the sheer enormity of the political and economic problems she faces. Eventually, if this crisis is going to be resolved in a way that creates a sustainable European economy, Merkel will have to commit Germany to permanent and constant transfers of wealth from the core to the periphery of the eurozone. She will also want to ensure some control over how this money is spent and to force reform of the southern economies.

The resultant deepening of mutual responsibility in Europe – both for northern taxpayers to help out the South, and for the South to buckle down under northern dictates – could not be created by a single, snap decision but must come about as the result of a long process of small steps that generate political will. As each individual step will ultimately be unsatisfactory to the markets, new pressure will be created for further action, further summits, and further steps towards a comprehensive solution. Merkel seems to be pursuing such a strategy purposefully. While her actions have been likened to a game of chicken, they are more akin to tightrope walking while composing an opera. Lurking in the background is the threat that the markets will lose faith and tear the whole edifice down – either way, this pact will not be the last word. Not even close.

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