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Prescription proves hard to swallow

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HIGH & LOW FINANCE

NEW YORK If the European monetary union is something like a bad marriage, what can be done to avoid a messy and disastrous divorce?

Broadly speaking, there are now two prescriptions. One calls for sacrifices and compromises from all sides.

The other, echoing laws that used to exist in many countries, is simple: The husband — Germany — should rule. Did not the wife promise to obey? It is too late to try to get out of that agreement.

At the heart of the euro system problem is that most of the rest of the countries are no longer competitive with Germany. They are running large current account deficits, and the existence of the euro means they cannot devalue their currencies to gain instant competitiveness.

With no currency adjustment possible, a German central banker explained this week, "other things must therefore give instead: prices, wages, employment and output."

The question now, said Andreas Dombret, a member of the executive board of the German central bank, in a speech in Berlin, "is which countries have to shoulder the adjustment burden."

Mr. Dombret's answer is simple: Not Germany. "The deficit countries must adjust. They must address their structural problems, reduce domestic demand, become more competitive and increase their exports."

Until now, Germany has seemed more or less to get its way, albeit at the cost of having to put up money to avert disaster. Faced with German anger, both Greece and Italy jettisoned elected governments in favor of governments run by "technocrats" who would do the right thing, as seen from Berlin. "Merkozy," the combination of Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France, dominated European summit meetings.

But now the European political winds seem to be moving against Germany. The Dutch government, which had been Germany's staunchest ally in demanding more and more austerity from the so-called peripheral countries, found it could not get that prescription through its own Parliament. Elections are expected later this year.

More ominously from a German point of view, Mr. Sarkozy's own future seems to be tenuous. On Sunday, he finished second in his bid for a second term, behind François Hollande, the Socialist candidate who has been calling for less austerity and more efforts to stimulate economic growth. The runoff vote will be held May 6.

The day after the French voted, I listened to Jens Weidmann, the president of the German central bank and formerly a top adviser to Mrs. Merkel, speak to the Economic Club of New York and throw down the gauntlet. Departing from his prepared text, he warned that agreements previously made must be respected and added that the necessary fiscal union meant that some "national sovereignty" would have to be sacrificed. Mr. Hollande talks about amending Europe's fiscal treaty mandating austerity; Mr. Weidmann views it as sacred.

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"Let us say that monetary policy becomes too expansionary for Germany," Mr. Weidmann told the Economics Club. "If this happens, Germany has to deal with this, using other, national instruments."

The idea that Germany knows best, and that what is best for it is best for the euro zone as a whole, is growing less and less popular in the rest of Europe. In northern Italy, some companies are muttering about a German conspiracy to devastate the Italian economy to enhance the prospects for German companies.

It may be significant that in the first round of the French election, extremist parties of the right and left garnered more than 30 percent of the votes, up from about 18 percent five years ago. The biggest surprise was the strength of the anti-immigrant National Front party, which received nearly 18 percent. Both Mr. Sarkozy and Mr. Hollande wasted no time in trying to appeal to those voters. In the Netherlands, it was the defection of a rightist, anti-immigrant party that led to the government's collapse.

Anger is on the rise in many countries. That worries a lot of people, and politicians in many countries are talking about the need to pursue policies that will bring growth soon, rather than in some distant future.

But there is little evidence that the Germans are concerned. During his speech to the Economics Club, Mr. Weidmann conceded that the German prescription of austerity for all "might, under normal circumstances, dampen aggregate demand and economic growth." But, he added, these are not normal times.

"A widespread lack of trust in public finances weighs heavily on growth," he said. "There is uncertainly regarding potential future tax increases, while funding costs are rising for private and public creditors alike. In such a situation, consolidation might inspire confidence and actually help the economy to grow." Andrew Mellon, President Herbert Hoover's Treasury secretary, could not have said it better.

Germany has been by far the biggest beneficiary of the euro. Its manufacturers have prospered in no small part because the lack of competitiveness of other euro-area countries has held down the value of the currency. Were the currency to collapse, Germany would suffer greatly. A new Deutsche mark would no doubt rise rapidly against other currencies, damaging the country's competitiveness.

But there is little evidence that the Germans are worried about views in the rest of Europe, among either politicians or increasingly bitter electorates. I asked one German I know how Mrs. Merkel would cope without Mr. Sarkozy at her side. He professed unconcern. A President Hollande, he said, would no doubt come around, once he was in office.

The fact that there is no easy way to break up the euro zone — and that no one can be sure just how painful it would be — is the best reason to think that, somehow, this marriage will endure. But Germany's rigid belief that others must suffer to preserve the system may yet make some other country decide to take the risk.

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