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The southern euro

To solve the European financial crisis, we need two different eurozones

Read this article in German

The euro crisis was the consequence of structural divergence between the 'northern' hard-currency countries, which have export-oriented economies, and the 'southern' soft-currency states, which are dependent on domestic demand. Following the crisis, a new euro regime was introduced that attempted to forcibly bring about economic convergence between north and south by imposing fiscal austerity and curbing wages. This structural transformation has dampened domestic demand in the former soft-currency countries and resulted in the loss of potential output and jobs.

Such a one-sided programme that privileges the north and only demands sacrifices in the south would never been accepted by voters in the southern states. So it had to be imposed, using technocratic intergovernmental processes that attempted to mask the political nature of the distributional conflict between north and south.

Such attempts have only been partially successful, and there have been calls for symmetrical adjustments to be made in the north and for a rapid reduction in the German export surplus. Of course, given the size and structural uniqueness of the German economy, these calls have little prospect for success. And if, more feasibly, a transfer union could be successfully set up in the face of German opposition, this could deepen the economic and political divide in the eurozone even further.

As a result of the structural divergence between the economies of individual eurozone members, the threat of potential crisis continues to loom over the currency union. This is despite the deceptive air of calm that currently prevails, thanks primarily to the ECB's unconventional and highly controversial monetary policy.

We need to look beyond the framework agreed in 1992, which established an inflexible currency union that can only be stabilised by

coercive means, and attempt to find more flexible solutions that promise long-term stability. Given its political and economic clout, it falls to Germany to take the necessary initiative.

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The investor and philanthropist George Soros already proposed a solution a few years ago: given the scale of the gap between Germany and the eurozone average, Germany should quit the euro rather than attempting to impose its will on other countries – and then have to pay the bill indefinitely.

Of course, Germany will never actually take this step. However, at the lowest point of the last-but-one Greek crisis, the German finance minister Wolfgang Schäuble did suggest that *Greece* (temporarily) leave the euro. The proposal, floated in an unofficial working document from in 2015, was flatly rejected.

It offered Greece continued EU membership and participation in all EU programmes, as well as support during the transition to its own currency. A report by the American economist James K. Galbraith has since revealed that the Greek finance minister Yanis Varoufakis had already made preparations for such a transition (the so-called Plan X). Ultimately, the government of Alexis Tsipras rejected this plan, partly because it doubted whether the offer would hold up under political pressure. Mainly, though, it found the idea of a future isolated from Europe more terrifying than capitulating to the harsh demands of its creditors.

There were two crucial things that Schäuble was unable to offer: firstly, valid rules for a mutually agreed departure from the eurozone; secondly, clear prospects for future relations between Greece and the eurozone after this departure. However, it would be possible to create these preconditions. And the institutional building blocks for a flexible, two-tier European monetary association are already in place: the existing currency union would simply need to be combined with the European Exchange Rate Mechanism (ERM II).

The ERM II is the successor to the European Monetary System (EMS) set up in 1979 by the German chancellor Helmut Schmidt and the French president Giscard d'Estaing. The EMS obliged member states to use the means afforded by their national monetary and financial policy to maintain agreed exchange rates, and to mutually support each other by

intervening in the currency markets.

This two-tier structure could be revived for Greece and other countries that want to link their currency to the euro and enjoy the protection a monetary association offers against fluctuations and speculative attacks on the currency markets, but are unable or unwilling to fulfil the strict conditions of a currency union.

In the two-tier monetary association I am proposing, the closer-knit currency union would include the former 'Deutschmark bloc' countries and the Baltic member states, and perhaps also Ireland, Spain and other countries that seek structural convergence with Germany for economic or political reasons and would be willing to pay the price of stronger coordination and controls in return. The decision of whether to join this union would pose more of a dilemma for France.

ERM II, by contrast, would allow much greater structural variation among its members. As well as the typical 'southern' states, it could also include countries like Denmark or Sweden with export-oriented economies and high price stability that have steered clear of the currency union not because of divergence in economic structures but because they do not want to give up the autonomy of a democratically accountable economic policy.

All members of ERM II would be obliged to maintain an agreed exchange rate with the euro, which some might find easier than others. However, this exchange rate would be based on the competitiveness of a particular economy, and in order to secure the rate each state would have at its disposal all the tools of a national monetary, finance, wage and credit policy tailored to its individual economic circumstances.

If there were nonetheless temporary imbalances or speculative attacks on one of the currencies, the almost unlimited firepower of the European Central bank would be available for stabilising interventions on the currency markets. Moreover, a European currency fund like that proposed by Schäuble in another connection could be set up in order to relieve liquidity bottlenecks in state finances.

For states threatened with bankruptcy, there would need to be a procedure enabling debt restructuring. Finally, in the event of persistent current account imbalances, there would be the option to adjust the exchange rates.

This would mean that countries in the core currency union would no longer be under political pressure to reduce their export surplus and

achieve convergence with the eurozone average. They could integrate their economic and financial policies more closely and benefit from finally having a functioning common monetary policy and countercyclical fiscal capacity.

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By contrast, in ERM II the former eurozone members from the south would no longer be forced to achieve convergence with German export levels, which are exceptionally high by international standards. They would simply need to ensure that they run a trade surplus, with exports higher than imports – which would in principle be just as possible with a very small export sector, for instance one focused on olives and tourism, as with a very large one. But at the same time, the monetary association would protect them from the danger of uncontrollable devaluation–inflation–devaluation cycles and attacks by currency speculators.

These benefits might also motivate other countries that are not currently part of the eurozone to join – Sweden or Poland, for example, or perhaps even Norway and Switzerland. This European monetary association would then have even more clout on the global financial markets and in international financial negotiations than today's eurozone.

However, the biggest winner from a flexible monetary association would be European politics, which would no longer be paralysed by the suppressed north–south conflict. Moreover, Germany would no longer be Europe's disciplinarian, imposing authoritarian policies that appear to serve nobody's interests but its own. Freed from the coercive regime of today's currency union, European politics would finally be able to make progress on tackling common crises and challenges that demand concerted action.



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