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Germany's Merkel: She's Got the Whole Euro in Her Hands

Angela Merkel, the EU's most powerful leader, has to save Europe from itself

By Peter Coy

Angela Merkel has no children of her own, but in the inner circles of her political party she is called Mutti—"Mom." The 55-year-old German chancellor has managed to stay in power since 2005 by governing quietly, cautiously, and pragmatically from the center right of a country that prizes smooth cooperation among big business, big labor, and big government. Although supersmart—she earned a doctorate in physics as a young woman in Communist East Germany—Merkel likes to pose as an ordinary citizen, comparing her economic policies to those of a provincial housewife who simply wants to balance the family budget. She and Germany are well suited to each other.

Now Merkel and Germany face a crisis, originating in dysfunctional Greece. As head of Europe's biggest economy and the country that has ladled out billions to support the European Union, she has emerged as the key player in the drive to save Greece from default, stem the bond market attacks on the euro, and instill fiscal discipline in the euro zone's weakest members. "There's no one else who can really match her power," says Roland Berger, a Merkel adviser and founder of Munich-based Roland Berger Strategy Consultants.

Yet Merkel is also hemmed in by circumstances. To understand this crisis it helps to understand the limits of the European monetary union. From the beginning, financial leaders such as European Central Bank President Jean-Claude Trichet have controlled the single currency but not the national budgets of member nations; the EU, in other words, has tools of monetary policy at its disposal but not fiscal policy. And the 1991 Maastricht Treaty, which tried to impose fiscal sanity by limiting national deficits to 3% of gross domestic product, has been routinely flouted, most egregiously by the Greeks.

Stunted and Stunned

Without a clear mechanism for a bailout, Merkel says Germany won't give a single euro to Athens until Greece shows backbone and cuts its budget. German voters approve of this stance: For years they've been enduring painful industrial restructuring as well as cuts in the German welfare state; they're not in a giving mood. Germany Inc. wants Merkel to support a stable euro as well and avoid costly bailouts or loans that could seriously damage confidence in the currency. Says Josef Ackermann, CEO of Deutsche Bank (DB): "The economic and

monetary union was set up as a hard currency union, and acceptance of the euro by the German population would be seriously undermined if it were turned into a soft currency."

Germany has fought hard for a credible euro that enjoys global standing. More to the point, letting Greece's woes wreck the euro would hurt German business, which has built much of its strategy around the euro zone. "The euro has helped increase financial stability in Europe," says Jörg Schneider, chief financial officer of Munich Re, the giant reinsurer. "We've had no currency crises like we saw before."

Until now. That's why Merkel, thrifty as she is, may still have to fork out billions in German funds even if Greece manages only halting reforms. She doesn't want to cave in to the Greeks, but she also cannot afford to let the euro get so hammered by further attacks that Spain, Portugal, and Italy—the entire southern flank of the euro zone—slide into fiscal collapse as traders short their bonds the way they did Greece's. Even after the European Union pledged to support Greece, nervous investors are demanding four extra percentage points of yield to hold Greek bonds instead of safer German ones. "I don't think anybody would be extremely worried about Greece for Greece's sake. But we are all extremely worried about Greece for the euro's sake," says Kurt Lauk, president of the economic council of Merkel's party, the Christian Democratic Union.

Not so long ago, another German chancellor, Helmut Kohl, faced a comparable but even costlier challenge: whether and how to bring the dysfunctional economy of the former East Germany, stunted and stunned by four decades of Communist rule, into political and economic union with the West. Kohl's solution—the trillion-dollar takeover called reunification—became the greatest and most controversial crusade of his life. It came to be hated by many West Germans, who resented its inefficiencies and costs, but eventually, fitfully, painfully, it worked. Eastern Germany came back to life; Kohl's vision knitted together East and West. Today, one of the people who embodies Kohl's achievement is the child of East Germany who became his protégé and successor: Angela Merkel.

If Merkel were to try to save southern Europe the way Kohl saved the East, her task would be no less arduous and only somewhat less expensive than his. To relieve the market's fears about Greece and the other fiscally feeble euro zone countries would require the EU to pledge more than $400 billion in potential aid, according to a report by French bank BNP Paribas. Germany would not have to pay all of that, but its share would be bigger than any other country's if such a rescue occurred.

Adding to the strain is a second problem that has received much less attention—the unstable imbalance between rich, export-dependent Germany and the indebted European countries that buy its goods, take its loans, and host its factories. That's not just Greece, but Spain, Portugal, Ireland, and Italy as well. If the intra-European imbalance isn't dealt with, the entire euro zone will be subject to even greater stresses. For Germany, in other words, the status quo that has been so profitable for so long is becoming perilous.

Since World War II, Germans have successfully studied, saved, invested, and sold high-quality goods to the rest of the world. BASF, Bayer, Bosch, Daimler (DAI), Infineon, Miele, Siemens (SI), SAP (SAP), ThyssenKrupp, and Volkswagen are just some of Germany Inc.'s marquee exporters. The Germans have sacrificed plenty to extend their success. When the nation joined the euro zone in 1999, unemployment was over 10% and the country was locked into monetary union at a time when the deutsche mark was overvalued. So Germany boosted productivity and clamped down on wage growth. "In effect they did a devaluation by

improving their competitive situation," says André Sapir, a senior fellow at Bruegel, a Brussels-based think tank. Even as the euro strengthened against the dollar and the pound, German exports rose 65% from 2000 to 2008.

The trouble is that Germany's trading partners in the euro zone, which buy 43% of its exports, can't improve their competitiveness against the country by depreciating their currencies, the traditional remedy. In essence, by locking themselves into the euro, Germany's exporters have a currency that works very much in their favor. Greeks and Spaniards want German goods and don't have to pay in devalued drachmas and pesetas to get them. The euro provides German companies other advantages as well. Says Frank Asbeck, chief executive of Bonn-based SolarWorld, a major maker of solar products: "We do two-thirds of our business in euro land. The currency makes things easier—no hedging, it's transparent, the business formalities are the same."

If Germany still had its old currency, the deutsche mark would doubtless be stronger than it is now, crimping its competitiveness against other European states. So inside Europe, Germany is in effect working with a currency that is undervalued and thus supercompetitive. That makes the country a lot like China, which has kept its exports cheap by pegging its currency to the dollar against the wishes of the American government. Last year, Germany's surplus on its current account—the broadest measure of goods and services—was 5% of GDP.

But the Greek crisis has exposed a flaw in Germany's business model. Seduced by membership in the euro zone, many of the country's trading partners overborrowed and overspent in the boom times. High inflation made their wages and products less and less competitive, especially against Germany. They can no longer afford to buy all those products without the ability to make some money selling something back to the Germans, or at least generating more exports in general. Their foreign debts—a reflection of the deficits they've been running—have been growing to unsustainable heights. They need more balanced trade. And so does Germany, which would be healthier if its citizens consumed more and relied less on exports for growth. "It's a pathology. The Germans are way too far in surplus," says Gary Herrigel, a University of Chicago political scientist specializing in Germany.

Clearly, something has to give. But what? In a Feb. 17 column in *The Financial Times*, Harvard University economist Martin Feldstein called for temporarily bringing back the drachma, letting Greece float its currency and set its own debt and interest-rate policies. But that option isn't on the table because it could lead to the breakup of the euro zone and the end of the decades-long movement toward European unification. Most Germans remain committed to being good Europeans, in part as penance for having plunged the Continent into two world wars in the 20th century.

If Germany's trading partners can't depreciate their currencies, they can only regain competitiveness quickly by lowering workers' pay. But that's disastrous for countries like Greece, where workers have taken on big debts, because it means employees have to pay back their loans with shrinking paychecks. The mix of debt and joblessness could trigger a downward spiral of defaults, bankruptcies, and bank failures. That would be lethal for the likes of Greece, and no good for Germany, either, because its companies need viable customers.

"Incompatible Values"

The alternative path for Merkel—call it the Kohl road—is bound to be unpopular at home. And its chances of success are far from assured. It would require Germany to ease the pressure on its trading partners by giving them more loans and outright aid while simultaneously buying more of their products to help those countries earn their way back to good health. Of course, Germany has been doling out money to poorer European nations for years, but many economists say it needs to go even further. "For their good fortune, they should share the wealth," says Adam S. Posen, a senior fellow at the Peterson Institute for International Economics in Washington. (Posen is also a member of the Bank of England's rate-setting Monetary Policy Committee and said his remarks are personal opinions, not British policy.)

This prescription raises a question: Can Spain, Greece, and the rest of the southern tier provide the goods and services, from Italian design to Greek island getaways, that Germans want to buy? Can these economies learn to innovate? Spain showed signs of doing so, but something, possibly bubble fever, slowly choked off its dynamism. Change won't come quickly, but if there is no change at all, these imbalances will only get worse. And they will slowly tear the euro zone apart.

Just as Kohl saved the East and then spearheaded the effort to introduce the euro, Merkel could aid the southern European countries now, continuing Kohl's tradition of enlightened self-interest. Geopolitically, Germany cannot be strong if the rest of the Continent is weak, Marko Papic and Peter Zeihan, analysts for Stratfor global consultants, said in a Feb. 8 opinion piece. "The only way for Germany to matter is if Europe as a whole matters," they wrote.

Not surprisingly, Germans resent being asked to open their wallets to Greeks who, in their view, behaved irresponsibly and lived beyond their means. "I know the mentalities of the southern European countries very well, and I know exactly how they think and what concept of the world their thinking is based on. These are incompatible values," says Anton Boerner, head of Germany's BGA wholesale and export federation. "You don't get this into the heads of southern Europe's population."

Boerner may condescend, but he has a point. The Greeks, in particular, brought this mess upon themselves. Nevertheless, helping Greece and other stressed countries keep their economies intact and avoid debt-deflation spirals could be what's required to avoid a Continental meltdown. John Maynard Keynes, the British economist who diagnosed the Great Depression, argued that in a steep downturn, trade deficit countries aren't capable of bearing all the costs of correcting imbalances—trade surplus nations must share the burden. Another student of the Depression, American economic historian Charles P. Kindleberger, argued that free trade depends on an anchor country that's willing to be an importer and lender of last resort in a crisis. In this case, that would be Germany.

Germany Comes First

Merkel shows few signs of Keynesianism. She's taking a hard line with Greece. As for boldly reshaping Germany so it consumes more imports, that's not in her talking points either. Last October, a month after winning reelection as chancellor, she told a labor convention in Hanover that "Germany's strength lies largely in the fact that the Federal Republic is a center of industry and that it's an export nation." Lest there be any doubt, Merkel added: "All those who now say we've depended too much on exports are undermining our biggest source of prosperity and must be rebuffed."

For Germany to lead Europe out of its slump would require heavier deficit spending to stimulate the country's economy and suck in imports. Merkel's government expects the budget deficit to swell to 5.5% of GDP this year, almost double the 3% ceiling technically required of euro zone members. Although Germany could easily afford a spurt of further stimulus given its rock-solid AAA rating, Merkel has been heading in the other direction, seeking greater fiscal probity. That, too, goes over well with the aging German populace, which is piling up wealth for retirement. The chancellor pushed for last year's constitutional amendment restricting Germany's structural budget deficit to just 0.35% of GDP, which requires her to start shrinking the budget gap in 2011.

In other words, Merkel may have the whole euro zone in her hands, but it's not at all clear she welcomes the responsibility. "Merkel is being forced by events in the Greek crisis," says Fredrik Erixon, director of the European Centre for International Political Economy in Brussels. "In such a situation you can't do medium- or long-term planning. You just try to arrest the source of what's causing unrest in markets."

Merkel's reluctance to stretch Germany's balance sheet so European growth can be propped up may stem in part from her own history. She was born after the Nazi era and "views Europe less emotionally" than her mentor, former Chancellor Kohl, says Gerd Langguth, a Merkel biographer and political scientist at the University of Bonn. Adds Roland Berger: "She's not burdened by history. She's simply pragmatic. She knows what she wants and thinks what she does is in the interests of Germany and Europe. She is a European, yes, but Germany comes first."

Merkel's woman-of-the-people approach is what helped her win a second four-year term as chancellor in September. She and her husband, Joachim Sauer—a quantum chemist at Berlin's Humboldt University—are both in their second marriages after divorces. "Merkel comes across as utterly normal, and the average German can really relate to her," said Carl Graf von Hohenthal, a management adviser at the Brunswick Group and former deputy editor-in-chief of Germany's *Die Welt* newspaper, who has known her since 1990. "She dresses well but doesn't wear overly expensive clothes." Merkel wheels a shopping cart through her local food store, trailed by her security detail, at least once a month. She even bags her own groceries. "She doesn't smoke, she doesn't drink much—power is her thing," said Friedrich Thelen, former parliamentary editor of the business magazine *Wirtschaftswoche* and founder of Thelen-Consult, a Berlin-based business advisory group.

If power really is her thing, then Merkel knows that retaining it depends on keeping business happy. And while German taxpayers gripe about bailing out Greece, German companies are more sensitive to the losses they would suffer if Greece and other European nations slipped under. Case in point: Merck KGaA in October said unpaid receivables from Greek hospitals had surpassed 50 million euros, calling the unpaid debts a "very serious situation" that could affect margins in its drugs division. Some of Germany's biggest companies, such as automakers Daimler, BMW, and Volkswagen, or infrastructure equipment maker Siemens, sell their goods all over the world, so their fates aren't tied up in any one region. But the crucial small and midsize manufacturers, the Mittelstand, are very dependent on the health of the European market and want to see it keep growing.

German banks, too, are highly exposed to the risk of rising defaults. Hypo Real Estate Holding, nationalized by the German government during the financial crisis, has a large exposure to the sovereign debt of Portugal, Ireland, Italy, Greece, and Spain. Hypo Real Estate has some $5 billion in Greek public debt alone.

All of these problems are complicated by an unanticipated lapse in the economic recovery of Germany and Europe. In the last three months of 2009, German economic activity was flat and the euro zone grew at an annual rate of just 0.1%. Slow or nil economic growth makes Germans even more reluctant to extend aid to others. If the slowdown is bad for Germany, it's devastating for Greece, which is being asked to cut government spending at the same time that its economy is contracting—the opposite of the Keynesian prescription for recovery.

Plenty of Credibility

If Merkel does embrace a bigger role for Germany in the economic recovery of Europe, it will be because she has been persuaded that it's in the long-term interest of Germany to make its export markets healthy and stable again. The first step for Merkel would be to speak out more clearly on Greece. "We're past the point where constructive ambiguity is constructive," says the Peterson Institute's Posen. "It's not like you're going to scare the Greeks into behaving any different." Opponents of aid say that bailing out Greece would encourage future misbehavior by it and others. The solution to that so-called moral hazard is to make the conditions so onerous and the monitoring so intensive that no other country would be tempted by it.

Beyond that, Merkel could offer up a vision of a Germany that no longer depends on a business model of extracting its growth from abroad. History tells us that one way or another, Germany is going to have to open its wallet to end this crisis, as it has so often in the past. But simply handing out money won't fix the imbalances that caused the crisis. For years, skeptics in the U.S. and Britain have argued that the euro experiment was doomed to fail. Now even true believers are concerned that something must be done, and soon, to relieve the mounting stresses on the system. "A common currency is right for Europe. It is the ideas behind the euro regime which are rotten and dangerous," German economist Jörg Bibow, who teaches at New York's Skidmore College, wrote last year.

Merkel has built up credibility to burn as a defender of German interests. Germans know their "Mutti" is watching out for them. That puts her in the best position of anyone to tell the German people that the old ways aren't working anymore, and Germany must change. Her former boss had the guts to say that to his people. Will she?

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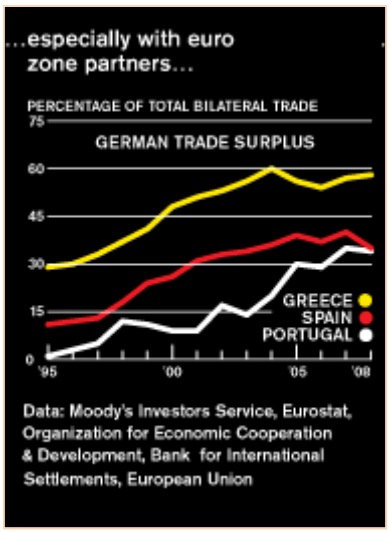
Euro Trap

Some people say Greece should abandon the euro. Yet in a 2007 commentary, University of California at Berkeley economist Barry Eichengreen said that exiting the monetary union would be a procedural nightmare. Virtually any contract—including those governing employment, mortgages, and bonds—would have to be redenominated in the domestic currency. Everything from parking meters to vending machines would have to be replaced or modified


Germany runs huge trade surpluses...
CHINA
$328
GERMANY
134
JAPAN
81
NORWAY
48
TAIWAN
34
WORLD'S LEADING CURRENT ACCOUNT SURPLUSES, 2009 EST. IN BILLIONS OF DOLLARS
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union


...especially with euro zone partners...
PERCENTAGE OF TOTAL BILATERAL TRADE
GERMAN TRADE SURPLUS
75
60
45
30
15
0
'95
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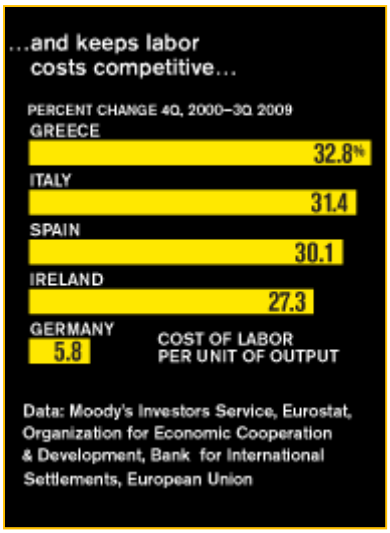
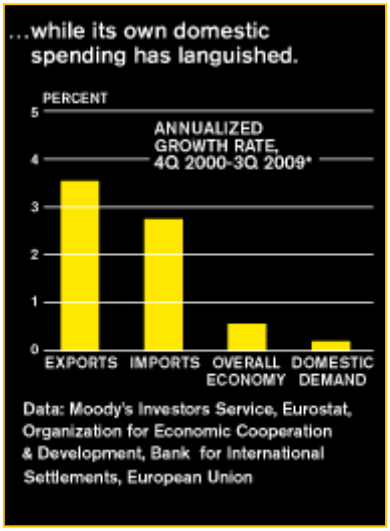
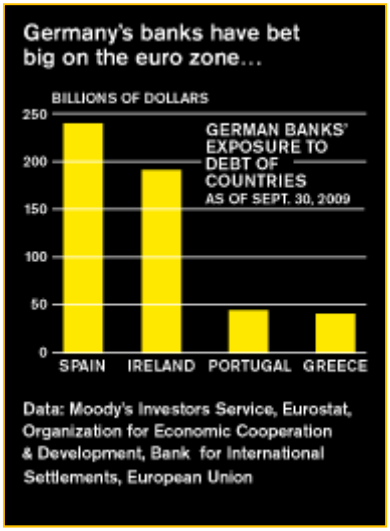
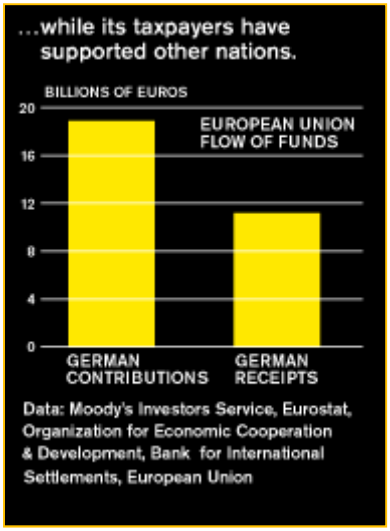
'05
'08
GREECE
SPAIN
PORTUGAL
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union


...and keeps labor costs competitive...
PERCENT CHANGE 4Q, 2000–3Q 2009
GREECE
32.8%
ITALY
31.4
SPAIN
30.1
IRELAND
27.3
GERMANY
5.8
COST OF LABOR PER UNIT OF OUTPUT
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union


...while its own domestic spending has languished.
PERCENT
ANNUALIZED GROWTH RATE, 4Q 2000-3Q 2009*
5
4
3
2
1
0
EXPORTS
IMPORTS
OVERALL ECONOMY
DOMESTIC DEMAND
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union


Germany's banks have bet big on the euro zone...
BILLIONS OF DOLLARS
GERMAN BANKS' EXPOSURE TO DEBT OF COUNTRIES
AS OF SEPT. 30, 2009
250
200
150
100
50
0
SPAIN
IRELAND
PORTUGAL
GREECE
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union


...while its taxpayers have supported other nations.
BILLIONS OF EUROS
EUROPEAN UNION FLOW OF FUNDS
20
16
12
8
4
0
GERMAN CONTRIBUTIONS
GERMAN RECEIPTS
Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, European Union