A Map for the Future of the Euro
Navigating Political Conflicts

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The Future of Europe series

Invesco’s Future of Europe series aims to address some of the most pressing questions surrounding the euro, the eurozone (EZ) and the European Union (EU). Grounded in economic and political reality and drawing on both theory and experience, it seeks to provide investors with an informed and practical framework for assessment and decision-making.

Co-authored by Jacek Rostowski, a former Deputy Prime Minister and Finance Minister of Poland, and Arnab Das, a Global Market Strategist and member of Invesco’s Global Thought Leadership team, the series examines Europe’s troubled past, uncertain present and possible future. This is the first in what we plan as a series of five papers, subject to the evolution of European affairs:
- A Map for the Future of the Euro: Navigating Political Conflicts
- The Survivability of the Euro: Reform, Relevance and Robustness
- The Internal Politics of the EU: Protest, Populism and “Peak Europe”
- Geopolitics: Economic Giants, Political Pygmies and the Scope for a “Money for Muscle” Deal in the EU
- From Brexit to the Balkans: Peripheral Perspectives on the Eurozone

The euro, the EZ and the EU arguably represent a unique experiment in the annals of economics and politics. The Future of Europe series is intended to shed light on the challenges and opportunities presented by this unprecedented and ever-contentious effort to achieve integration across a continent whose history has been one of almost continuous political competition and conflict.
1. Executive summary

- We believe that the future of the euro and the future of the EU are essentially one and the same now that the UK plans to leave the EU after having opted out of the euro. The euro and the EU are being shaped by a number of conflicts, tensions and dynamics.
- We argue that these challenges are to be found both within and beyond Europe. They include the US’s inward turn, Russia’s expansionist ambitions, Brexit and the spread of populism and nationalism within the EU and the eurozone.
- We suggest that Franco-German relations will drive European progress now more than ever. However, we posit that a shift in the balance of power between the two demands that all member states reassess where they stand, what they might ask of the EU for themselves and what they might require of other member states.
- We expect the euro and the EU to survive, but three broad scenarios remain real possibilities: deeper integration; the status quo; and even eventual disintegration – despite several decades of European economic integration and nearly two of monetary union.
- We infer that the persistence and rising prominence of such different possibilities point to greater diversity and variability in country risk premia in the coming years, in stark contrast to the convergence that was the hallmark of the euro’s first decade and the divergence of its second.

2. Introduction

“Who do I call if I want to talk to Europe?” – Henry Kissinger

Variations of the above quote are habitually aired when the pros and cons of ever-closer European ties are debated. Originally viewed as a criticism of Europe’s failure to adopt a single foreign policy, it has gradually come to encapsulate disinclination towards meaningful European integration – let alone decisive leadership. Kissinger himself has long cast doubt on whether he actually said it, although he did once concede: “It’s a good statement, so why not take credit for it?”

Speaking at an event in Warsaw in 2012, at the height of the eurozone crisis, America’s arch proponent of realpolitik commented on the enduring relevance of the remark. “Even if a telephone exists and even if they answer it,” he said, “the answer is not always very clear. Europe has the capacity to be a superpower, but it has neither the organisation nor – so far – the concept to be a superpower. And that is a challenge for the European idea.”

This “idea” has seldom proven easy to realise, for no confederation of nations can ever fully escape the problems of interstate politics. The fundamental notion of a united Europe has been beset by growing pains ever since the signing of the Treaty of Rome in 1957, and the all-consuming question of how “widening” can be made compatible with “deepening” is still with us today. The situation is in many ways becoming increasingly complex and urgent, as World Economic Forum founder Klaus Schwab acknowledged last year when he observed: “Europe has been in almost constant crisis since the eruption of the global financial crisis, yet no shared sense of what needs to be done and in what order has yet emerged.”

It still seems reasonable to suggest that the euro, the eurozone (EZ) and the European Union (EU) will continue in some form. This remains an immensely significant political undertaking – even if the prevailing philosophy has often appeared to be one of merely “muddling through” – and its total derailment is unlikely. It is also right to say that Europe is capable of influencing the world when it presents a united front, especially with regard to low politics and soft power: see, for instance, the effective extraterritoriality of EU regulations and their acceptance in other jurisdictions. Yet quite what shape the European project might take in the years ahead is much harder to determine.

In this paper we look at the conflicts and tensions at play. We consider the changing nature of the crucial relationship between Germany and France; we examine the growth of Europe’s political “wings” – represented by the political right and left and the geographic north and south – and their potential impact on longstanding interstate dynamics; we assess the roles of the US and Russia in shifting the balance of power within and around Europe; and we delineate the implications for the region in general and the EZ in particular.

We do not pretend – less still guarantee – that the scenarios we attempt to analyse here will inevitably come to pass. We do, though, argue that they reflect structural risks that need to be recognised and confronted; that they are likely to influence the organising principles underpinning the longer-term fate of the euro, the EZ and the EU; and that they must be explored and understood if Europe’s epic “to do” list is at last to be defined by a genuine sense of perspective and progress.

“This remains an immensely significant political undertaking – even if the prevailing philosophy has often appeared to be one of merely ‘muddling through’.”
3. Core tensions

### 3.1. Germany, France and the locomotive of European integration

Europe’s destiny has frequently depended less on what happens within countries than on what happens between countries. Perhaps nowhere is this more evident than in the case of Germany and France, the two nations customarily – and rightly – regarded as constituting the principal locomotive of integration. If we want to understand why Franco-German relations lie at the heart of Europe’s future then we must first revisit Europe’s past.

It could be argued that the post-war quest for European union formally began with the Treaty of Paris in 1951. This created the European Coal and Steel Community, whose underlying political goal was to strengthen links between the Germans and the French – mainly through the pooling of the raw materials required for economic reconstruction. The ensuing years saw several proposals for further “communities”, covering concerns such as defence and energy, and the Treaty of Rome eventually followed in 1957.

What has since become a familiar pattern was thus established. The trope that meaningful progress in Europe relies on Franco-German agreement still holds true today. This is not to say that the relationship has been one of ever-obliging accord, for it has regularly been anything but: rather, it is to say that only when Germany and France do concur – or compromise – can European integration actually progress.

By contrast, alliances with the UK have routinely come to nothing. Consistently favouring the status quo, Britain managed to divide the more political from the more commercial, effectively driving a wedge into European decision-making at least until the Brexit era. Despite supporting liberalism in structural economic policies – flexible labour markets, openness to the world in trade, investment, migration and EU economic integration – the UK promoted national sovereignty in matters of high politics, preferring policies, as well as national fiscal and monetary policies, between joining NATO and transatlantic considerations to guide defence and foreign relations – Part I

Germany and France have enjoyed a close relationship for more than half a century. This has often allowed them to advance both their own interests and those of Europe as a whole, despite regular disagreements.

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tbody>
<tr>
<td>1951</td>
<td>The European Coal and Steel Community is established to strengthen economic links between the Federal Republic of Germany (FRG) and France</td>
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<tr>
<td>1955</td>
<td>The FRG becomes a full member of NATO and is formally welcomed into the organisation in a ceremony at Paris’s Palais de Chaillot</td>
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<td>1956</td>
<td>The Treaty of Luxembourg returns control of the Saar region to the FRG, ending a long-running dispute between the two countries</td>
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<td>1957</td>
<td>Along with Belgium, Italy, Luxembourg and the Netherlands, the FRG and France sign the Treaty of Rome, the first constitutional basis for the EU</td>
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<td>1959</td>
<td>President Charles de Gaulle begins France’s gradual withdrawal from NATO, in part as a protest against the US’s dominant role</td>
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<td>1963</td>
<td>Chancellor Konrad Adenauer and de Gaulle sign the Élysée Treaty to build cooperation on issues such as foreign policy</td>
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<td>1965</td>
<td>Relations cool after Ludwig Erhard, Adenauer’s successor, fails to see eye-to-eye with de Gaulle over the future of Europe</td>
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<td>1966</td>
<td>Meeting at the 11th Franco-German summit, both governments express their support for the development of the European community</td>
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<td>1974</td>
<td>On the initiative of Chancellor Helmut Schmidt and President Valéry Giscard d’Estaing, the European Council is established</td>
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<td>1977</td>
<td>Schmidt and Giscard d’Estaing submit a proposal for a European Monetary System to the European Council</td>
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<tr>
<td>1982</td>
<td>Chancellor Helmut Kohl and President François Mitterrand institutionalise their governments’ cooperation on military and security matters</td>
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The euro itself provides a classic example of these dynamics in action. In the late 1980s, amid continued wrangling over the prospect of a single European currency, Germany and France were very much at odds: the former insisted that other types of integration should precede monetary union, while the latter was keen on monetary union and little else. The powerful financial shock of the ERM I currency crisis should have been a cautionary tale – aside from Germany, almost no country survived unscathed these first major steps towards monetary union – despite the flexibility offered by currency trading bands. The UK was blown out of the currency arrangement, as were many other members – though France was insulated by Bundesbank currency swap lines. As a result, the UK ploughed its own furrow and edged towards an opt-out as discussion proceeded on the euro.

So the question arose: whence would the ever-essential advent of Franco-German cooperation spring? It was the fall of Communism that ultimately led to conciliation. Afraid that the reunification of Germany would create an economic titan and maybe even trigger a return to militarism, the French seized their opportunity. President François Mitterrand offered Chancellor Helmut Kohl a trade: support for a united Germany in exchange for support for the euro. Not for the first time, a pivotal deal was struck. With the usual stokers in place, the locomotive of European integration gathered steam once more, pulling along most of the rest of the EU; and yet the journey did not unfold at all as planned.

“The only when Germany and France do concur – or compromise – can European integration actually progress.”
3.2. Unintended consequences and role reversals
The French and the British firmly believed that Mitterrand and Kohl’s deal would weaken Germany. Ironically, the very opposite occurred. In time, having tackled the difficulties that reunification brought, Germany was transformed from the “sick man” of Europe into the economic powerhouse that its neighbours had originally feared.

This, in turn, had a largely unforeseen effect: Germany gradually cast off its federalist tendencies to become increasingly nationalist – not in an extremist sense but in terms of how it framed its own existence. Having previously defined itself through its membership of the EU and NATO, it rediscovered its self-identity. No longer a partial state, it set about placing greater emphasis on its own domestic economic interests.

This entailed becoming less disposed towards change. Germany may have been railroaded into accepting the euro earlier than planned, but the conditions it had imposed for the single currency’s construction and introduction were very much to its liking. On the whole, the Maastricht Treaty served its needs. It realised that this particular status quo was very much to its taste, and it reasoned that things might therefore usefully stay just as they were. For some years now, with other European countries having few cards to play against it, Germany has done quite well by saying no.

Meanwhile, France has moved in the other direction. Promoting the ideal of “gouvernance économique” – a concept that is still fiercely disputed almost three decades later – it was the French who picked up the federalist baton that the Germans had cast aside.

So today a country that once wanted multifaceted integration while showing comparative reluctance towards the euro has become a country that wants the euro while showing comparative reluctance towards multifaceted integration; and a country whose federalist leanings once focused almost exclusively on monetary union has become a country that yearns to move far beyond a shared currency. Confused? Well, at least the UK has continued to toe much the same old line – if anything more so, with Brexit.

The tensions inherent in the relationship between Germany and France are still central to the future direction of the euro, the EZ and the EU. A switching of positions has not altered this fact, and the locomotive of European integration is still liable to churn into life only if these two nations are able to find common ground. Almost 70 years after the Treaty of Paris, more than 60 years after the Treaty of Rome and in the absence of any alternative engines of consolidation, there is no doubt that agreement between Germany and France remains necessary for Europe’s progress: we now turn to the less obvious but all-important question of whether it is still sufficient.

“A selected history of post-war Franco-German relations – Part II

1987
Kohl and Mitterrand attend the 50th Franco-German summit and agree even greater levels of coordination and cooperation

1990
Mitterrand offers Kohl support for German reunification in return for support for the adoption of a single European currency

1998
Chancellor Gerhard Schröder and President Jacques Chirac adopt a declaration on their countries’ driving role in reshaping European policy

2002
Franco-German agreement on a reform of the common agricultural policy helps pave the way for a further enlargement of the EU

2003
In an unusual move that underscores the closeness of relations, Chirac speaks on Schröder’s behalf at the European Council

2005
Angela Merkel, Schröder’s successor, holds a joint press conference with Chirac to reaffirm the importance of Franco-German relations

2007
On the day he is sworn in as Chirac’s successor, Nicolas Sarkozy travels to Berlin for his first official meeting with Merkel

2009
At a summit marking the 60th anniversary of the organisation’s founding, Sarkozy confirms France’s decision to seek full reintegration into NATO

2010
Merkel and Sarkozy unveil a proposed roadmap for the next decade of collaboration and cooperation between their countries

2012
Merkel and François Hollande, Sarkozy’s successor, express contrasting opinions on the steps the EU should take to bring about economic recovery

2018
Merkel and Emmanuel Macron, Hollande’s successor, pledge to deepen cooperation and “give the whole of Europe a new boost”

“The tensions inherent in the relationship between Germany and France are still central to the future direction of the euro, the EZ and the EU.”
4. New dynamics

4.1. Populism and the present day

The landscape of European politics has become pockmarked with populism. From Greece to Finland, from the Netherlands to the Baltics, anti-globalisation and anti-European sentiment is finding favour and generating fervour. The resulting emergence of two political "wings" - one northern, one southern - calls into question the longstanding assumption that Franco-German consent should be enough to drive change.

It is important to give some thought to this phenomenon here, even though we will explore its broader implications in more detail in a later paper, because it has introduced a new dynamic that poses a substantive challenge to the existing European order. Some of populism’s architects and enthusiasts may have no wish to destroy the euro, the EZ or the EU; yet they are still capable of inflicting damage, even if unwittingly.

We should perhaps begin by explaining what we understand by “populism” in today’s context. Europe has witnessed the rise of populism before, but populism as we know it now is not fascism - let alone Nazism. It might be seen as outrageous, even contemptible, but it is not the same as what occurred in the 1920s and 1930s.

Fascism grew out of desperation. Its spread was a product of the Great Depression, whose crippling effects far exceeded those of the Great Recession that followed the global financial crisis. The people to whom today’s populist politicians appeal are not in despair: they might be disenchanted, angry, hungry for something different, but they have not suffered the acute collective depravations that blighted Europe and elsewhere in the two decades before World War II.

What is happening now is more akin to events leading up to World War I. With their protectionist rhetoric and their zeal for isolationism, populist parties are characterised by excessive optimism and a bent for overestimating their own strength - the same flaws that paved the way for the Great War. Just as is it was widely believed that what eventually came to be known as the War to End All Wars would prove blessedly swift, so populists think that easy wins are within their grasp.

Such confidence is misplaced. Even trade wars are seldom short or painless. Instead, as we will explain in the next section, it is more likely that populists will contrive to prevent easy wins for anyone.

"Some of populism’s architects and enthusiasts may have no wish to destroy the euro, the EZ or the EU; yet they are still capable of inflicting damage, even if unwittingly."

A decade of populism

Populism’s appeal has mushroomed in many countries in the years since the global financial crisis, even though economic considerations are seldom uppermost on its protagonists’ political agendas. The following chart shows how populist parties’ share of the vote has changed across the EU during the past decade.

4.2. “Hot” politics and the north-south divide
From the fall of communism in 1991, having by and large dominated European politics in the latter half of the 20th century, the centre-left and the centre-right moved further towards the political centre. Depending on one’s perspective, this duopoly could be seen either as highly nuanced or as a system expressly configured to deliver “more of the same”. In seeking to offer an alternative, populists have predictably moved away from the middle ground and towards the extremes.

As stressed in the previous section, it is too simplistic to surmise that this lurch can be attributed solely to discontent over the economic repercussions of the Great Recession. The vote for Brexit clearly flew in the face of economic reality; so, too, did the rise of Poland’s protectionist Law and Justice Party after years of unprecedented prosperity. It seems fair to suggest that populism rarely thrives on a meticulous understanding of all things economic.

Instead, at least for now, it thrives on the controversy surrounding issues such as mass migration and cultural liberalisation. Maybe above all, it thrives on public opposition to the alleged surrendering of national sovereignty. Thanks to populist parties’ dogged focus on these emotive and profoundly divisive matters, Europe’s political battleground is becoming increasingly “hot”; and, by extension, effective compromise is becoming ever more elusive.

One reason for this is that the populists cannot even agree among themselves. We can roughly divide them into two wings: the northern populists, including the likes of the Netherlands and the Baltics, which tend to be right-leaning; and the southern populists, including the likes of Italy and Greece, which tend to be left-leaning.

Remember that in the past meaningful progress required agreement between Germany and France and that this was often tricky to achieve. Now consider this: in terms of political outlook, albeit somewhat crudely speaking, the northern populists might be described as more German than the Germans and the southern populists as far more French than the French.

The question, then, is whether those occupying what now passes for the centre of the political spectrum can still expect to force through their own consensus when either or both of the populist wings might torpedo all hopes of cooperation. This is a fundamental problem of the new political structure that has evolved in Europe during the past decade. With the poles of policy now much farther apart, the way forward for federalism and integration will be anything but smooth.

“Europe’s political battleground is becoming increasingly ‘hot’; and, by extension, effective compromise is becoming ever more elusive.”
5. External pressures

5.1. “America first” and the end of the West

A recurring cornerstone of populism since the French Revolution has been the idea that a state and a nation should be one and the same. The staunchest and most powerful proponents of this tenet – which stands in stark contrast to that of the European project – can today be found in the US and Russia, whose geostrategic decisions are likely to have a major impact on Europe’s future path. Let us begin with arguably the world’s most vocal populist, President Donald Trump, and the potential corollaries of his “America first” policies.

It is no great secret that Trump is hostile towards the EU. The infamous photograph of him sitting cross-armed and indignant while being addressed by a stony-faced Angela Merkel quickly became the defining image of June 2018’s G7 summit, with the sense of meltdown only heightened by the subsequent revelation that the Commander-in-Chief had plucked two sweets from his pocket, tossed them towards the German Chancellor and told her: “Don’t say I never give you anything.” Yet his antagonism is in many ways even more intense than is generally recognised.

In Brussels and Washington alike there is a firm conviction that Trump would be only too delighted to see the EU fall apart. Although some maintain that his aggression towards Europe is the stuff of bombast, many of those who have talked to him personally or undertaken high-level duties in the US on the EU’s behalf have little doubt that his enmity goes beyond the purely symbolic. As he told The Times in an interview conducted by UK Conservative MP Michael Gove last year: “Basically, [the EU is] is a vehicle for Germany. That’s why I thought the UK was so smart in getting out.”

It would be ill-advised to rule out the risk of a US-EU trade war – one in which Germany, with its huge trade surplus with the US, would be hit notably hard – despite the “breakthrough” declared after Trump’s July 2018 meeting with European Commission President Jean-Claude Junker. Trade tensions seem to us very likely to recur, given the size of Germany’s trade surplus in particular and the post-crisis shift in the EZ current account from rough balance to the world’s largest surplus. US-EU trade frictions should be considered in the context of US tensions with other major geopolitical rivals and surplus economies: both transatlantic and transpacific trade tensions have a geostrategic character.

Indeed, Trump is also no fan of NATO and has linked western collective security – NATO especially – with US-EU and US-Germany trade imbalances, implying both that the EU is free-riding on US support for NATO and that Germany is free-riding on asymmetric access to US markets. Criticising those countries that “we’re supposed to protect”, he told Gove: “It’s obsolete... A lot of these countries aren’t paying what they’re supposed to be paying, which I think is very unfair to the United States.” His attitude in this regard raises the possibility that Europe’s key defence guarantee might be hollowed out – a scenario that, for reasons we will explain further, would again impair Germany’s position more than most.

As we stressed at the outset, we do not guarantee that such events will take place. There are numerous “unknownables”, not least when the “leader of the free world” is a man who routinely gives the impression of formulating policy decisions as he is climbing into or out of his limousine. Informed commentators point out that the current administration is essentially Reaganite – pro-Western, anti-Russian and intrinsically Atlanticist – at every level bar its highest echelon. Trump might not be around for long, less still forever. But our aim here is to assess how “old knowns” and “new knowns” are likely to interact in the foreseeable future.

For now Europe’s longest-established and most potent ally has a president whose priorities lie altogether closer to home. Trump’s conspicuous determination to put the US first at every turn jeopardises the very notion of “the West” – particularly since, as we will examine next, Russia is similarly bent on pursuing its own interests at Europe’s expense.

“In Brussels and Washington alike there is a firm conviction that Trump would be only too delighted to see the EU fall apart.”
5.2. Russia and the question of security

President Vladimir Putin’s unwaveringly tight embrace of nationalism has presented many populist movements with an appealing prototype. It has shown that resolute patriotism, especially in the relative absence of liberal democracy, can garner widespread domestic backing. It has also served as a platform for Russia’s efforts to expand its sphere of influence.

In light of everything discussed so far, we therefore need to contemplate the likely shape of a Europe in which – internally – populism’s competing wings threaten hopes of further integration; in which neither the EU nor NATO enjoys unconditional US support; and, crucially, in which Russia looks to fill the resultant void. Should such a perfect storm develop, on balance, it is Germany that is likely to be caught in its eye.

To understand why this is so, particularly with Russia’s ambitions in mind, we first need to reflect on Germany’s military capacity. Germany’s spending on defence has been cut repeatedly since 1990 and currently accounts for approximately 1.2% of GDP; NATO’s target is 2%. Much of the Bundeswehr has outdated equipment, and the country’s defence industry is poorly placed to respond to any sudden demand for additional production. Every one of Germany’s submarines was in dry-dock for repairs in late 2017, while there have been periods when none of its transport planes has been deemed airworthy. In February 2018 Armed Forces Commissioner Hans-Peter Bartels admitted that deployment readiness had not only failed to improve but had “got even worse”. Moreover, while its conventional capabilities are severely limited, Germany’s nuclear capability is non-existent.

Of course, this is a complex state of affairs. We must not disregard Germany’s post-war sensitivities and its move towards pacifism and soft power; nor should we forget either its neighbours’ fears that it would revert to militarism after reunification or the role of those fears, as recounted earlier, in precipitating the euro’s adoption. Nonetheless, the uncomfortable reality is that Germany’s armed forces now appear remarkably ill suited to the emerging dynamics of today’s geopolitical environment.

Consequently, the more fragile NATO becomes, the more Germany is liable to fixate on its remaining security pillar: the EU. There is a slim chance that Berlin could adopt a Bismarckian view – that is, it could try to cultivate stronger relations with Russia – but it is far more likely to search for solutions among its fellow federalists; and those solutions could play a key part in deciding the future of the euro, the EZ and the EU.

At this stage it may be worth pausing to recollect the words of Lord Ismay, NATO’s first Secretary General, in outlining the alliance’s objectives more than 60 years ago: “Keep the Russians out, the Americans in and the Germans down.” US foreign policy expert John Hulsman, a former associate of the German Council of Foreign Relations, more recently rephrased this imperative as follows: “Keep the Russians out, the West in and the isolationists down.” One way or another, the picture today is far removed from these ideals.

“The uncomfortable reality is that Germany’s armed forces now appear remarkably ill suited to the emerging dynamics of today’s geopolitical environment.”

The peace dividend and security in “Europe’s back yard”

In 1988, the year before the fall of the Berlin Wall, Germany spent more than €30 billion on its military; throughout the 1990s and for much of the 2000s, as a reunified and “full” state, it spent slightly more or, more often, slightly less; and in 2017 it spent in excess of €40 billion.

Overall, this suggests that spending has been reasonably consistent and is now rising. However, as the following chart shows, a different story emerges when the trajectory is viewed through the prism of defence spending as a percentage of GDP.

![Chart showing defence spending as a percentage of GDP](image-url)
6. Shifting balances

6.1. Germany and the north

Given the core tensions between Germany and France, the internecine conflicts provoked by the spread of populism and the external pressures exerted by the US and Russia, it might be tempting to infer that Europe stands in utter disarray. This would be something of an exaggeration, but we should at least acknowledge that all of these factors raise the likelihood of instability and fragmentation and that they could also set in motion a significant rebalancing of power.

One reason why such a rebalancing would negatively impact on Germany, as we have already seen, is its chronic lack of investment in defence. Under a weakened NATO, along with other nations in the north, Germany would be left more vulnerable to events beyond its eastern border. A second reason – which is by no means unrelated to the first – is its fiscal policies, which have fuelled its trade surplus and, according to some critics, contributed to protectionism elsewhere.

Germany’s overall trade surplus reached a record high of €248.9 billion in 2016. In 2017 it recorded its first decline since 2009, slipping to €244.9 billion – not nearly enough to temper outside disgruntlement over an overtly export-oriented economy that has long infuriated other nations. The problem for Germany is that in President Trump it has finally found a detractor who is sufficiently powerful and sufficiently incensed to do something about the issue.

Germany’s trade surplus with the US topped €66 billion in 2017. Unfortunately, what the Trump administration has yet to realise is that the most promising course of action does not lie in launching trade wars and hurling Starbursts across tabletops during summit meetings. Tariffs might initially reduce European exports – nowhere more so than in the case of Germany – but even if successful they will make the dollar more expensive, which will translate into fewer US exports and a return to square one; and this is even before we account for the direct impact that tit-for-tat reprisals by the EU would have on the US’s trade deficit. The vast majority of economists agree that the source of Germany’s trade surplus is that it saves too much given what it is willing to spend at home on consumption, investment and – to use a pertinent example – defence. One sensible long-term strategy might therefore be to urge Germany to save less and spend more, thereby transforming its balance of payments; or, given that asking for something and offering nothing in return smacks of political naïveté, it would be even more sensible to think about how Germany might be induced to save less and spend more – a crucial question that we will return to in a later white paper.

Germany’s reliance on imported energy also merits mention here. Germany is phasing out its nuclear plants and closing its coalmines as part of its Energiewende – literally, the “energy transition” to renewables. In 2016, the most recent year for which data is available, 32% of its coal and almost 40% of its oil came from Russia; and in 2015, again the most recent year for which data is available, 34% of its gas came from Russia. This underlines the prospective frailty of its bargaining position in a Europe enfeebled by disintegration and diminished security.

Meanwhile, many of the other probable losers seem blissfully unaware of their likely fate. A classic illustration can be found in Poland, whose enthusiasm for populism ignores the fact that a weakening of the EU and NATO would fundamentally undermine its national security. This, again, is the over-optimistic mentality that preceded World War I. It is remarkable how frequently something truly bad can happen when a nation convinces itself that no such thing could occur.

Germany’s fiscal policies have fuelled its trade surplus and, according to some critics, contributed to protectionism elsewhere.

### The problem of Germany’s energy dependency

Germany’s long-term reliance on imported energy could increase its vulnerability to pressures beyond its eastern border. The following chart shows how it scarcely improved its position in this regard in the decade between 2006 and 2016.

![Bar chart showing primary energy consumption in hard coal units (HCU) for Germany, 2006-2016](image-url)

6.2. France and the south

If politics is a zero-sum game - as President Trump, for one, appears to believe - then Germany’s loss of power should be another country’s gain. It follows that this country, at least in certain vital respects, should be the opposite of Germany. This brings us back to France.

France has the largest military in the EU and the sixth-largest in the world. It maintains a nuclear deterrent that is smaller only than those of Russia and the US. In February this year, after proposals for budgetary belt-tightening prompted the resignation of the head of the armed forces, the government announced plans to raise defence spending from €34.2 billion in 2018 to €50 billion in 2025 - a trajectory in line with NATO’s target of 2% of GDP. France’s Defence Minister, Florence Parly, has spoken of a policy of “renewal”.

France’s trade surplus with the US is also more in tune with American sensitivities. In 2017, according to European Commission figures, it was just €5.3 billion - or, according to US Census Bureau figures, around €13 billion. This may explain why the quandary of how to react to US tariffs quickly put a fresh strain on Franco-German relations. While Germany pushed for what Economy Minister Peter Altmaier described as a “constructive solution”, France - which has much less to lose - adopted a firm stance, with President Emmanuel Macron warning that trade wars “solve nothing”.

In terms of its energy security, too, France is in a healthier position. It is heavily reliant on its own network of almost 60 nuclear reactors, which are majority-owned by the government and together produce almost three quarters of the nation’s electricity. Although Energy and Environment Minister Nicolas Hulot has suggested that renewables should become “the norm”, Finance Minister Bruno Le Maire told an industry conference in June 2018 that nuclear “remains essential to guarantee France’s competitiveness, security and energy independence over the long term”.

And what of the other would-be winners? They are likely to be found in the south. If NATO is undermined then the likes of Italy and Spain may well benefit relative to Germany, if only because they are farther from Russia. Italy’s trade surplus with the US is second only to Germany’s, having reached almost €25 billion in 2017, which would not stand Rome in the best stead if tariffs should start to proliferate; but Spain’s, at less than a billion euros in 2017, is tiny.

There is one country whose destiny is harder to foresee, and that is the UK. Could it be that Britain’s military muscle, both in conventional and nuclear terms, could help rebuild its relationship with Europe after Brexit? A withdrawal of US protection might well strengthen the UK’s hand; and yet America’s shattering of global trade would work against Britain - a severe problem for the Brexiteers, who want the country to make entirely its own way in the world. This may have little direct bearing on the euro but might become a key part of the bigger, ever-shifting European picture.

Investing in security: a closer look at military spending

France’s defence expenditure in 2017 was €40.8 billion, of which more than 24% went on equipment. Germany’s total defence expenditure was similar - €40.4 billion - but less than 14% went on equipment. In the same year the US spent almost $686 billion on defence, with equipment accounting for nearly a third of this total. NATO’s recommended target for equipment expenditure is 20% of a country’s overall defence budget.

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“While Germany pushed for a ‘constructive solution’, France - which has much less to lose - adopted a firm stance, with President Emmanuel Macron warning that trade wars ‘solve nothing’.”
7. Conclusion: implications for the euro

The European project has endured a turbulent decade. Debt, migration and other cross-border shocks have made “crisis” part of its everyday language. Its hopes that populism might prove a mere fad have been dashed. Russia’s annexation of Crimea has forced it to establish a new security policy. The US’s inward turn has compelled it to reassess its global footing – both in economic and security terms – and has exacerbated abiding schisms between Germany and France, the two countries that have long served as the principal agents of progress.

Franco-German relations still hold the key to what lies ahead. Indeed, they might be more valuable now than ever before, because they have to be strong enough to resist the many forces – Europe’s growing and more extremist political wings, the US’s explicit antagonism, Russia’s expansionist aspirations, divergent notions of the future of the euro – that have come to swirl around them. So exactly where do they stand today?

On one side we have a country whose leader seems to have wide-ranging ambitions for the EU. On the other we have a country whose brittle coalition government apparently believes that no such ambitions should be realised until a number of so-called “legacy problems” have been resolved. As the balance of power shifts in light of the various conflicts described in this paper, will both sides recognise the trade-offs that Europe’s new political dynamics demand?

Given its pre-eminence since reunification, Germany may have a right to feel that other EU nations have been free-riding on its success or have neglected to exhibit the resolve and rigour that it showed in escaping its own economic woes. Yet it could soon be that the French will have equal grounds to complain that Germany is free-riding on France’s security guarantee if the US’s commitment ceases to be credible.

This alone exposes as unrealistic the idea that some kind of grand resolution of legacy issues is required if Europe is to move forward. No country can claim to have a completely clean slate, and attempts at score-settling could go on forever. The past may offer a rough guide, but what really matters is the present. Where the euro, the EZ and the EU go from here depends much less on where they might have been before and much more on where they are right now.

Will both Germany and France appreciate how their positions are changing? Will the northern and southern wings follow suit? Will all concerned understand how these adjustments might shape an ethos of quid pro quo that could underpin – and maybe even cement – the future of the euro, the EZ and the EU? Will there finally emerge a clearly defined vision of what needs to be done and, just as importantly, what does not need to be done? Will Henry Kissinger’s successors ever find out whom they should call? We will address such considerations in more detail in our next paper, which will deal with the core question of the euro’s survivability.

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**Market and investment implications – at a glance**

**Scenario 1: further integration**
Serious progress between countries is likely to lead to significant and sustained compression of country risk premia. This would apply across bonds, credit and equity.

**Scenario 2: status quo**
No progress on further integration but credible limits to centrifugal forces – for example, Outright Monetary Transactions and the European Stability Mechanism – should make country risk premia pro-cyclical. The risk of national exits would vary.

**Scenario 3: towards disintegration**
Successful secessionist movements underpinned by populism/nationalism are likely to permanently widen some country risk premia. This would be the case even if there were no actual exits or a disintegration of the euro.
8. Suggested further reading and references

**Suggested further reading**

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**References**

1. The Markets in Financial Instruments Directive and the General Data Protection Regulation are two recent examples of the EU’s success in regulatory export. In a subsequent paper we will explore in more detail the growing importance of Europe’s ability to present a united front to the world – at least when it comes to economic policy, if not in politics and foreign policy.

2. This might now be changing. As we explain in section 4, the rise of populism within countries is today redefining what can happen between countries. One of the ultimate ironies of recent European history is that Britain has occasionally pushed for much deeper integration. It was Winston Churchill, speaking in 1946, who first proposed a “United States of Europe” to avoid further war on the continent; in the late 1980s Margaret Thatcher championed the idea of the single market to achieve better economic union; and in 2011 Chancellor George Osborne called for fiscal union to address the eurozone debt crisis.

3. Issues such as this will be examined in more detail and from a more technical perspective in subsequent papers. We have roughly equated populism with nationalism and use them almost interchangeably, despite their formal distinction in academic political economy. This is because today’s most influential populists in both Europe and the US are at once populists (in the sense of asserting the rights of “ordinary” people against the “establishment”) and nationalists (in the sense of redefining the national interest in zero-sum terms against other countries or the international system, which they seem to see as a construct of the elites, for the elites and by the elites). One of the enduring ironies here is that Trump is thus the billionaire “people’s president” whose policies may well further enrich domestic elites at the relative expense of “regular” voters - as with Brexiteers, many of whom hail from the socioeconomic elite.

4. “America first” was first used by Woodrow Wilson during his successful presidential election campaign in 1916. Ironically, Wilson subsequently led the US into World War I and then set about founding the League of Nations – an idea that the US Congress duly rejected. A non-interventionist pressure group, the America First Committee, resurrected the slogan in 1940 in a failed bid to keep the US out of World War II. This is not to suggest, of course, that we should expect World War III anytime soon: rather, it is simply to say that the isolationism at the heart of “America first” has not proven sustainable - though it is true that global disasters like the Great Depression and World Wars were required to draw the US out of its shell.

5. Gove was a leading Brexit campaigner and still holds a key ministerial position at the time of writing.

6. Pulitzer-Prize-winning author and political commentator Anne Applebaum, writing in the Washington Post after Trump’s election in November 2016, remarked: “Under President Trump, we cannot assume that America is still the leader of the free world.”

7. Germany’s military weakness would also damage its hopes of successfully pursuing this option while maintaining its foreign policy sovereignty. The Netherlands might prove an exception, although it seems fair to assume that the Dutch are as concerned as the British when Russian planes stray towards sovereign airspace over the North Sea.

8. One way this might be achieved is for pressure from the US, France and the south of the EU to lead to the adoption of a properly symmetrical Stability and Growth Pact. Member states could be required to increase fiscal deficits - to be spent at home - if they were currently judged insufficient for the achievement of an optimal EZ-wide fiscal stance or if their external current account deficits were judged excessive under the Macroeconomic Imbalance Procedure. Ironically, Trump’s pressure to significantly step up defence spending pushes in this direction.

9. Trump has highlighted this dependence, sewing yet more division within the EU, by asserting that it renders Germany a “captive” of Russia. Speaking ahead of a NATO summit in July this year, he said: “Germany, as far as I’m concerned, is captive to Russia, because it’s getting so much of its energy from Russia. So we’re supposed to protect Germany, but they’re getting their energy from Russia.”

10. For reasons that have long been debated, the European Commission and the US Census Bureau seldom produce similar figures when calculating trade balances. We plan to return to this possibility in a forthcoming paper, Geopolitics: Economic Giants, Political Pygmies and the Scope for a Money-for-Muscle Deal in the EU.