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[www.afgazad.com](http://www.afgazad.com)

[afgazad@gmail.com](mailto:afgazad@gmail.com)

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## Germany's Choice: Part 2

By Peter Zeihan and Marko Papic

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Seventeen months ago, STRATFOR described how the future of Europe was bound to the decision-making processes in Germany. Throughout the post-World War II era, other European countries treated Germany as a feeding trough, bleeding the country for resources (primarily financial) in order to smooth over the rougher portions of their systems. Considering the carnage wrought in World War II, most Europeans — and even many Germans — considered this perfectly reasonable right up to the current decade. Germany dutifully followed the orders of the others, most notably the French, and wrote check after check to underwrite European solidarity.

However, with the end of the Cold War and German reunification, the Germans began to stand up for themselves once again. Europe's contemporary financial crisis can be as complicated as one wants to make it, but strip away all the talk of bonds, defaults and credit-default swaps and the core of the matter consists of these three points:

Europe cannot function as a unified entity unless someone is in control.

At present, Germany is the only country with a large enough economy and population to achieve that control.

Being in control comes with a cost: It requires deep and ongoing financial support for the European Union's weaker members.

What happened since STRATFOR published Germany's Choice was a debate within Germany about how central the European Union was to German interests and how much the Germans were willing to pay to keep it intact? With their July 22 approval of a new bailout mechanism —

from which the Greeks immediately received another 109 billion euros — the Germans made clear their answers to those questions, and with that decision, Europe enters a new era.

### The Origins of the Eurozone

The foundations of the European Union were laid in the early post-World War II years, but the critical event happened in 1992 with the signing of the Maastricht Treaty on Monetary Union. In that treaty, the Europeans committed themselves to a common currency and monetary system while scrupulously maintaining national control of fiscal policy, finance and banking. They would share capital but not banks, interest rates but not tax policy. They would also share a currency but none of the political mechanisms required to manage an economy. One of the many inevitable consequences of this was that governments and investors alike assumed that Germany's support for the new common currency was total, that the Germans would back any government that participated fully in Maastricht. As a result, the ability of weaker eurozone members to borrow was drastically improved. In Greece in particular, the rate on government bonds dropped from an 18 percentage-point premium over German bonds to less than 1 percentage point in less than a decade. To put that into context, borrowers of \$200,000 mortgages would see their monthly payments drop by \$2,500.

Faced with unprecedentedly low capital costs, parts of Europe that had not been economically dynamic in centuries — in some cases, millennia — sprang to life. Ireland, Greece, Iberia and southern Italy all experienced the strongest growth they had known in generations. But they were not borrowing money generated locally — they were not even borrowing against their own income potential. Such borrowing was not simply a government affair. Local banks that normally faced steep financing costs could now access capital as if they were headquartered in Frankfurt and servicing Germans. The cheap credit flooded every corner of the eurozone. It was a subprime mortgage frenzy on a multinational scale, and the party couldn't last forever. The 2008 global financial crisis forced a reckoning all over the world, and in the traditionally poorer parts of Europe the process unearthed the political-financial disconnects of Maastricht.

The investment community has been driving the issue ever since. Once investors perceived that there was no direct link between the German government and Greek debt, they started to again think of Greece on its own merits. The rate charged for Greece to borrow started creeping up again, breaking 16 percent at its height. To extend the mortgage comparison, the Greek "house" now cost an extra \$2,000 a month to maintain compared to the mid-2000s. A default was not just inevitable but imminent, and all eyes turned to the Germans.

### A Temporary Solution

It is easy to see why the Germans did not simply immediately write a check. Doing that for the Greeks (and others) would have merely sent more money into the same system that generated the crisis in the first place. That said, the Germans couldn't simply let the Greeks sink. Despite its flaws, the system that currently manages Europe has granted Germany economic wealth of global reach without costing a single German life. Given the horrors of World War II, this was not something to be breezily discarded. No country in Europe has benefited more from the

eurozone than Germany. For the German elite, the eurozone was an easy means of making Germany matter on a global stage without the sort of military revitalization that would have spawned panic across Europe and the former Soviet Union. And it also made the Germans rich.

But this was not obvious to the average German voter. From this voter's point of view, Germany had already picked up the tab for Europe three times: first in paying for European institutions throughout the history of the union, second in paying for all of the costs of German reunification and third in accepting a mismatched deutschmark-euro conversion rate when the euro was launched while most other EU states hardwired in a currency advantage. To compensate for those sacrifices, the Germans have been forced to partially dismantle their much-loved welfare state while the Greeks (and others) have taken advantage of German credit to expand theirs.

Germany's choice was not a pleasant one: Either let the structures of the past two generations fall apart and write off the possibility of Europe becoming a great power or salvage the eurozone by underwriting two trillion euros of debt issued by eurozone governments every year.

Beset with such a weighty decision, the Germans dealt with the immediate Greek problem of early 2010 by dithering. Even the bailout fund known as the European Financial Security Facility (EFSF) — was at best a temporary patch. The German leadership had to balance messages and plans while they decided what they really wanted. That meant reassuring the other eurozone states that Berlin still cared while assuaging investor fears and pandering to a large and angry anti-bailout constituency at home. With so many audiences to speak to, it is not at all surprising that Berlin chose a solution that was sub-optimal throughout the crisis.

That sub-optimal solution is the EFSF, a bailout mechanism whose bonds enjoyed full government guarantees from the healthy eurozone states, most notably Germany. Because of those guarantees, the EFSF was able to raise funds on the bond market and then funnel that capital to the distressed states in exchange for austerity programs. Unlike previous EU institutions (which the Germans strongly influence), the EFSF takes its orders from the Germans. The mechanism is not enshrined in EU treaties; it is instead a private bank, the director of which is German. The EFSF worked as a patch but eventually proved insufficient. All the EFSF bailouts did was buy a little time until investors could do the math and realize that even with bailouts the distressed states would never be able to grow out of their mountains of debt. These states had engorged themselves on cheap credit so much during the euro's first decade that even 273 billion euros of bailouts was insufficient. This issue came to a boil over the past few weeks in Greece. Faced with the futility of yet another stopgap solution to the eurozone's financial woes, the Germans finally made a tough decision.

The New EFSF

The result was an EFSF redesign. Under the new system the distressed states can now access — with German permission — all the capital they need from the fund without having to go back repeatedly to the EU Council of Ministers. The maturity on all such EFSF credit has been increased from 7.5 years to as much as 40 years, while the cost of that credit has been slashed to whatever the market charges the EFSF itself to raise it (right now that's about 3.5 percent, far lower than what the peripheral — and even some not-so-peripheral — countries could access on the international bond markets). All outstanding debts, including the previous EFSF programs,

can be reworked under the new rules. The EFSF has been granted the ability to participate directly in the bond market by buying the government debt of states that cannot find anyone else interested, or even act pre-emptively should future crises threaten, without needing to first negotiate a bailout program. The EFSF can even extend credit to states that were considering internal bailouts of their banking systems. It is a massive debt consolidation program for both private and public sectors. In order to get the money, distressed states merely have to do whatever Germany — the manager of the fund — wants. The decision-making occurs within the fund, not at the EU institutional level.

In practical terms, these changes cause two major things to happen. First, they essentially remove any potential cap on the amount of money that the EFSF can raise, eliminating concerns that the fund is insufficiently stocked. Technically, the fund is still operating with a 440 billion-euro ceiling, but now that the Germans have fully committed themselves, that number is a mere technicality (it was German reticence before that kept the EFSF's funding limit so "low").

Second, all of the distressed states' outstanding bonds will be refinanced at lower rates over longer maturities, so there will no longer be very many "Greek" or "Portuguese" bonds. Under the EFSF all of this debt will in essence be a sort of "eurobond," a new class of bond in Europe upon which the weak states utterly depend and which the Germans utterly control. For states that experience problems, almost all of their financial existence will now be wrapped up in the EFSF structure. Accepting EFSF assistance means accepting a surrender of financial autonomy to the German commanders of the EFSF. For now, that means accepting German-designed austerity programs, but there is nothing that forces the Germans to limit their conditions to the purely financial/fiscal.

For all practical purposes, the next chapter of history has now opened in Europe. Regardless of intentions, Germany has just experienced an important development in its ability to influence fellow EU member states — particularly those experiencing financial troubles. It can now easily usurp huge amounts of national sovereignty. Rather than constraining Germany's geopolitical potential, the European Union now enhances it; Germany is on the verge of once again becoming a great power. This hardly means that a regeneration of the Wehrmacht is imminent, but Germany's re-emergence does force a radical rethinking of the European and Eurasian architectures.

### Reactions to the New Europe

Every state will react to this new world differently. The French are both thrilled and terrified — thrilled that the Germans have finally agreed to commit the resources required to make the European Union work and terrified that Berlin has found a way to do it that preserves German control of those resources. The French realize that they are losing control of Europe, and fast. France designed the European Union to explicitly contain German power so it could never be harmed again while harnessing that power to fuel a French rise to greatness. The French nightmare scenario of an unrestrained Germany is now possible.

The British are feeling extremely thoughtful. They have always been the outsiders in the European Union, joining primarily so that they can put up obstacles from time to time. With the Germans now asserting financial control outside of EU structures, the all-important U.K. veto is now largely useless. Just as the Germans are in need of a national debate about their role in the world, the British are in need of a national debate about their role in Europe. The Europe that was a cage for Germany is no more, which means that the United Kingdom is now a member of different sort of organization that may or may not serve its purposes.

The Russians are feeling opportunistic. They have always been distrustful of the European Union, since it — like NATO — is an organization formed in part to keep them out. In recent years the union has farmed out its foreign policy to whatever state was most impacted by the issue in question, and in many cases these states has been former Soviet satellites in Central Europe, all of which have an axe to grind. With Germany rising to leadership, the Russians have just one decision-maker to deal with. Between Germany's need for natural gas and Russia's ample export capacity, a German-Russian partnership is blooming. It is not that the Russians are unconcerned about the possibilities of strong German power — the memories of the Great Patriotic War burn far too hot and bright for that — but now there is a belt of 12 countries between the two powers. The Russian-German bilateral relationship will not be perfect, but there is another chapter of history to be written before the Germans and Russians need to worry seriously about each other.

Those 12 countries are trapped between rising German and consolidating Russian power. For all practical purposes, Belarus, Ukraine and Moldova have already been reintegrated into the Russian sphere. Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Romania and Bulgaria are finding themselves under ever-stronger German influence but are fighting to retain their independence. As much as the nine distrust the Russians and Germans, however, they have no alternative at present.

The obvious solution for these “Intermarium” states — as well as for the French — is sponsorship by the United States. But the Americans are distracted and contemplating a new period of isolationism, forcing the nine to consider other, less palatable, options. These include everything from a local Intermarium alliance that would be questionable at best to picking either the Russians or Germans and suing for terms. France's nightmare scenario is on the horizon, but for these nine states — which labored under the Soviet lash only 22 years ago — it is front and center.