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How to save the euro – kick out Germany

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The French and Germans have totally different visions for Europe. Sarkozy could make political capital from this

As Europe's "federal destiny" draws nearer, a second flaw in the European project, far deeper than the contradiction between the monetary and fiscal policies of the eurozone nations, is coming into view.

Everyone agrees that Europe faces a clear choice either to abandon the euro or make a quantum leap towards "true European economic government", as President Sarkozy put it after yesterday's meeting in Paris.

In practice this will mean two things. The first is a partial replacement of the debts of national governments by so-called eurobonds, jointly guaranteed by all eurozone nations and their taxpayers. This has been strongly opposed by Germany, Austria and other creditor nations, and was put off again yesterday, but resistance is weakening.

The second condition, demanded as a quid pro quo by the creditor countries, will be centralised control over taxes and government spending by a federal European treasury with veto powers over the fiscal policies of all member states. This has, of course, been strongly opposed by Greece, Italy, Spain and other debtor nations, but their resistance is also weakening. But putting Herman Van Rompuy, the EU President, in charge of a new committee was not much of a step down that route.

However, the first fundamental flaw of the euro project — the contradiction between a single currency and a multiplicity of divergent national fiscal policies — may still eventually be resolved in favour of the federal solution. This was always the intention of the euro's ultimate founding fathers, François Mitterrand and Helmut Kohl.

Now Europe must face the second flaw — that German and French conceptions of a federal Europe are mutually incompatible. Not only do the two nations have very different theories of government centralisation and devolution, much more crudely their visions of a federal Europe are fundamentally incompatible in terms of simple power politics.

The Germans believe that they are Europe's economic superpower, so have the right to manage the eurozone in accordance with their model. The French are equally convinced that their nation has historically been the diplomatic, intellectual and bureaucratic leader and see themselves as the natural managers of all European institutions. The really fundamental issue that must now be resolved if the euro is to continue is not whether a federal Europe is necessary, but whether the nascent federation will be run by Germany or France.

At present Germany is assumed to be dominant as it is the paymaster in the euro crisis, but if Mr Sarkozy plays his cards well he could prove this completely wrong.

Suppose that he reacts to yesterday's inconclusive summit with a modest proposal. Germany, he could argue, has refused to support the euro in this crisis. Berlin has neither agreed to issue jointly guaranteed eurobonds nor allowed the European Central Bank to refinance Italy, Spain and Greece by buying up their bonds. German politicians have argued that countries that cannot pay their debts should be expelled from the euro — but why not turn this around and expel Germany?

Given its lack of solidarity with other eurozone countries, Germany could be politely asked to leave. Or the decision could be triggered by a political revolt or court decision within Germany if the other euro members override its objections and force the ECB to buy vast amounts of Italian and Spanish debt. Germany would then issue a new mark and other countries would have a simple choice: follow Germany out of the euro or continue in a smaller French-led group, similar to the Latin Currency Union that linked France, Spain, Italy, Greece and Belgium from 1866 to 1908.

This southern pseudo-euro was nicknamed the sudo in a satirical article several years ago by Martin Taylor, the former Barclays chief executive. He suggested that northern countries such as Austria and the Netherlands, which are as neurotic about inflation as Germany, could create a rival common currency, called the neuro. But Germany's lack of appetite for further experiments in currency co-operation might not allow this.

Germany's voluntary withdrawal would raise far fewer legal and institutional problems than a break-up of the euro caused by forcibly expelling Greece, Italy or Spain. Germany could be granted a derogation from the Maastricht treaty, similar to that enjoyed by Britain and Denmark. Owners of German bonds would not object, as their holdings would be converted into a stronger currency, the new mark.

The ECB would continue as before, but with no German (or Dutch or Austrian) directors. With the German veto removed, the ECB would be free to purchase immediately unlimited amounts of Italian and Spanish bonds, just as the Bank of England and the US Federal Reserve have been buying their governments' bonds. Over time, the remaining euro members would negotiate a new treaty, creating a federal finance ministry charged with issuing jointly guaranteed bonds and administering common fiscal policies.

For all the Latin countries, including France, this would offer huge advantages and no real drawbacks. They would regain control of their currency and could use it to redeem their government debts. They could devalue it at will, without provoking trade wars with their Latin neighbours. For France the geopolitical benefits would be greater still: it would no longer be condemned to play second fiddle to Germany and would not lose national character by trying to make itself more German than Germany.

The countries of Central Europe would flock to join the sudo, as the alternative would be overvalued currencies. More importantly, Poland and Hungary would much rather view themselves as European countries following French leadership than German economic colonies.

Best of all for France, the French bureaucratic elite would again become unquestioned leaders of the European federal project.

Germany's exporters and banks, meanwhile, would suffer the mother of deflationary shocks — so much so that Germany might come crawling back with its tail between its legs, begging for permission to rejoin a monetary union ruled by France.

In short, French diplomacy now has the chance to establish once and for all its superiority over Germany industrial might as the dominant force in Europe. Where Clemenceau and Napoleon failed, Mr Sarkozy could yet triumph. Le jour de gloire est arrivé!