Expel Germany, not Greece, to save the euro

The truth is slowly dawning about Europe's real odd-man-out. France, Italy and Spain should form their own club

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The world has been watching with horror and fascination this week as investigators seek the cause of an eminently avoidable shipwreck in Italy. Meanwhile, the cause of a much greater shipwreck is coming into view. As Greece moves towards default, as France, Italy and Spain suffer credit downgrades, and as negotiations over last month's fiscal treaty reach deadlock, the euro is heading for the rocks and the driving force is becoming clear. The real cause of the euro disaster is not France, Italy or Greece. It is Germany.

The fundamental problem lies not in the efficiency of the German economy, although that has contributed to the divergence in economic fortunes, but in the behaviour of German politicians and central bankers.

Not only has the German Government consistently vetoed the only policies that could have brought the euro crisis under control — collective European guarantees for national debts and large-scale intervention by the European Central Bank. To make matters worse, Germany has been responsible for almost all the misguided policies implemented by the eurozone, ranging from last year's crazy interest rate rises by the ECB to the excessive demands for austerity and bank losses that now threaten Greece with a chaotic default.

Germany's culpability has been highlighted by a series of recent public statements, starting with last week's downgrade announcement from Standard & Poor's. This stated that "a reform process based on fiscal austerity alone risks becoming self-defeating" and that the German-inspired fiscal compact agreed over British objections at last month's European summit "is predicated on only a partial recognition of the source of the crisis" and would "not supply sufficient resources or operational flexibility" to restore stability to the eurozone.

Yesterday, Mario Monti, the German-appointed Prime Minister of Italy, was even more explicit, warning that Germany would suffer a "powerful backlash" if it persisted in opposing measures that could relieve financial pressures on other euro members, such as the issue of jointly guaranteed bonds. Meanwhile, many of the country's leading economists, former central bankers and business leaders have started writing articles advocating withdrawal from the euro on the ground that Germany's policies are incompatible with other members'.

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The dawning recognition that the odd-man-out in the eurozone is Germany makes it easier to understand the baffling twists and turns of the euro crisis and how it may end up. As Eurosceptics have argued since the early 1990s, there are ultimately just two possible outcomes for the single currency project. Either the euro will disintegrate or the eurozone will be transformed into a full-scale fiscal federation and political union. This dichotomy is now widely acknowledged. The question, however, is what exactly is meant by a "fiscal federation". This is where we get to the root of Germany's culpability for the present crisis.

For the euro to survive, three necessary conditions will have to be satisfied. The first, the one that Germany insists on, is the imposition of budgetary discipline, which can only be enforced by centralised EU control over the tax and spending policies of national governments.

The second condition is a substantial degree of collective European responsibility for national government debts and bank guarantees. This mutual support is the other side of the coin of fiscal federalism, as Mr Monti made clear in yesterday's interview, but it is a quid pro quo that the Germans have consistently refused even to discuss.

The third condition is support for the fiscal federation from the ECB, comparable to the monetary support provided for government debt markets by central banks in the US, Britain, Japan, Switzerland and all other advanced economies. It is because of this central bank support for their government bond markets that the US, Britain and Japan have managed to finance much larger deficits than France or Italy without any serious worries about credit downgrades.

Even if all these conditions were satisfied, the euro's long-term survival could not be guaranteed, since much of Europe would still face massive problems of unemployment and economic divergence. But without these three conditions of fiscal and monetary co-ordination, the euro crisis will surely move from bad to worse.

> Merkel is forcing ever more unrealistic austerity targets

The fundamental problem for the eurozone is that Germany concentrates entirely on the first. It forces other governments to adopt ever more draconian and unrealistic austerity targets while refusing even to discuss the quid pro quo of collective debt guarantees and central bank intervention.

Because of German intransigence on these two issues, the new euro treaty supposedly agreed last month is like a three-legged stool supported by one leg. If the German Government sticks to this position then the chances are that the treaty will never be ratified — incidentally vindicating David Cameron's refusal to take part.

Does this mean that the euro is now sure to disintegrate? Not necessarily, for two opposite reasons. The optimistic possibility is that last month's pointless "fiscal compact" was just a diversionary tactic while Angela Merkel prepared German political and public opinion for compromises that lie ahead on joint debt guarantees and the ECB engaging in Anglo-Saxon-style quantitative easing.

The pessimistic alternative is that Germany is genuinely determined to prevent the fiscal and monetary easing that is needed for the euro to have a chance of survival. If that is the case, then the other euro members will soon face an historic choice. Do they abandon the euro? Or do they expel Germany, either by simply asking it to leave or, more likely, by agreeing among themselves a monetary and fiscal strategy that would provoke Germany to walk out?

France, Italy, Spain and their eurozone partners have the means to save the euro and in the process they could escape German economic hegemony. The only question is whether they have the self-confidence and economic understanding to unite against Germany.

In any case, it will soon be time for Europe's leaders to stop blaming the euro crisis on the world economy or on the banks or on the profligacy of previous governments. As Shakespeare wrote: "The fault, dear Brutus, is not in our stars/ But in ourselves, that we are underlings."