

# The euro area's deepening political divide

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Ashoka Mody, 20 March 2018

Two European elections – in Germany on 24 September 2017 and Italy on 4 March 2018 – warn that the peoples of Europe are drifting apart. Much of the recent deepening of these divisions can be traced to Europe's single currency, the euro. This column argues that the political divide in Europe may now be hard to roll back absent a shift in focus to national priorities that pay urgent attention to the needs of those being left behind.

The University of Cambridge economist Nicholas Kaldor was first to warn that the euro would divide Europe (reprinted in Kaldor 1978). His critique came in March 1971 as a response to the Werner Commission Report, which presented the original blueprint of what would eventually be the euro area's architecture (Werner 1970). Kaldor wrote that a single monetary policy (and the accompanying one-size-fits-all fiscal policy framework), when applied to diverse European countries, would cause their economies to diverge from one another. The logic was simple: a monetary policy that is too tight for one country can be too loose for another. The economic divergence, Kaldor said, would cause a political rift. Such warnings continued. The University of Chicago economist and Nobel laureate Milton Friedman (1997) predicted that the euro's flawed economics would "exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues".

European leaders dismissed such naysayers. They insisted that the single currency would bring Europeans closer into a political union (Sutherland 1997).

## A permissive consensus?

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The discourse on the possibility of political union in Europe was conducted mainly within a group of so-called elites. These elites – political leaders and bureaucrats – had little basis to presume that national interests could be reconciled to unify Europe. But they made the further assumption that they had a "permissive consensus" from the public to make far-reaching decisions on European matters (Mair 2013). As I argue in a forthcoming book (Mody 2018), the permissive consensus began to break down about the time the single European currency became a political reality. Following the signing of the Maastricht Treaty in February 1992, the Danish public rejected the single currency in a referendum held in June 1992. And in September 1992, the French public came within a whisker of rejecting the single currency.

The voting pattern in the French referendum eerily foreshadowed recent political protests. Those who voted against the single currency tended to have low incomes and limited education, they lived in areas that were turning into industrial wastelands, they worked in insecure jobs, and, for all these reasons, they were deeply worried about the future (Mody 2018: 101–103). By voting against the Maastricht Treaty, they were not necessarily

expressing an anti-European sentiment; rather, they were demanding that French policymakers pay more attention to domestic problems, which European institutions and policies could not solve.

Over the following years, the permissive consensus continued to fray. The popular voice against 'more Europe' expressed itself again in referendums on a European Constitutional Treaty in 2005. Referendums allowed focus on European issues, which were crowded out by domestic priorities in national elections. European elites found it easy to dismiss the referendums as aberrations.

A critical new phase began during the financial crises of the past decade. After the onset of the Global Crisis in 2007 and then through the protracted euro area crisis, euro area monetary and fiscal policies hurt the lives of ordinary people who felt left behind – the less educated and those living outside of metropolitan cities. Euro area policies, however, remained insulated from political accountability to those whose prospects they most severely damaged. As a consequence, domestic rebellions gathered force throughout the euro area. These rebellions originated among similar people in the various member states, but they resulted in opposing national public responses in the northern and southern countries, increasing the political divide.

## The rise of Alternative für Deutschland in Germany

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The most virulent form of political division emerged in the crucible of the euro area financial crisis in 2012. The permissive consensus finally broke down. In Germany, long-time members of Chancellor Angela Merkel's Christian Democratic Union (CDU) formed a new political movement, Electoral Alternative, in September 2012. This new movement represented those who refused to accept Merkel's claim that Germany had no alternative but to support financially troubled euro area nations. In February 2013, Electoral Alternative converted itself into a political party, Alternative für Deutschland (AfD), which called for a breakup of the euro area.

Although AfD missed the threshold of 5% of votes cast for the September 2013 election to the Bundestag, it gained political strength starting in August 2015, following Merkel's open door to Syrian refugees. Seeing that she was losing popular support, Merkel quickly clamped down on refugee and migrant inflows, but AfD continued to gain political strength. In the September 2017 election, AfD received 12.6% of the vote. Many who voted for AfD in 2017 had not cast a vote in 2013, having lost faith that they have a voice in the democratic process. In 2017, these voters looked for solutions outside of the political mainstream. AfD voters had one very specific German feature: many were East Germans. Aside from that, however, the AfD vote manifested a pattern observed elsewhere in Europe and in the US. In East and West Germany, low-income men with only 'basic' school education or vocational training voted in large numbers for AfD (Roth and Wolff 2017). Most AfD voters were between the ages of 30 and 59; they worked in blue-collar jobs, often with little job security. They lived in small cities and rural areas.

Thus, economic protest and anti-immigrant sentiment overlapped in AfD voters, an overlap that Guiso et al. (2017: 5) find for several European countries. Even prosperous Germany had left behind many of its citizens. Marcel Fratzscher, president of the research institute

DIW Berlin, explains in his forthcoming book that the country's economic gains in the past few decades have not percolated to the bottom half of the German population (Fratzscher 2018). In this bottom half, real incomes have barely grown; few are able to save for a rainy day. Political alienation and conflict within society have increased.

With the CDU and the Social Democrats having experienced historic setbacks, a governing coalition proved difficult to form and Germany remained without a government for an unprecedented five months. Recently – coincidentally, on the same day as the Italian election, 4 March 2018 – the CDU and the Social Democrats finally agreed to form a 'grand coalition'. A German government will soon be in place, but polling data show continuing decline in popular support for the CDU and especially for the Social Democrats. AfD will be the largest opposition party in the Bundestag, and, for now, its support in the polls is rising.

## The anti-Europe movement in Italy

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Italian developments moved in parallel. Italy's Five Star Movement, headed by the comedian-blogger Giuseppe "Beppe" Grillo, rose from relative obscurity to prominence in the February 2013 election, garnering 25% of the vote. Italy had been in near-perpetual recession since early 2011, with mounting job losses, especially among young Italians. The Five Star Movement's call for direct democracy resonated with voters frustrated with European monetary and fiscal policies, which profoundly affected their lives but which they felt powerless to influence. The poorer southern areas voted for Five Star candidates. But whether in the north or the south, the share of votes received by Five Star candidates was higher in regions of higher unemployment (Romei 2018).

For Italians, indignities during the crisis years had come on top of economic stagnation since Italy entered the euro area in 1999. Economic productivity – the source of higher standards of living – stopped increasing, Italian producers lost international competitiveness, and well-paying manufacturing jobs began to disappear with nothing commensurate to replace them. The financial crises – first the Global Crisis that started in July 2007 and then the continuing euro area crisis – compounded Italy's economic and political dysfunction. Euro area authorities' emphasis on tight monetary policy and unrelenting austerity depressed economic growth and therefore had the perverse consequence of increasing the government's debt burden. Meanwhile, the enforced fiscal austerity crowded out the government's ability to cushion the economic pain of vulnerable citizens. And although ECB President Mario Draghi's announcement in July 2012 that the ECB would do "whatever it takes" to save the euro area helped bring down the nominal interest rate the Italian government paid on its debts, the 'real' interest rate (the nominal rate adjusted for inflation) remained high. The Italian economic squeeze continued. In early 2013, the average Italian was poorer than at the time of entry into the euro area.

In the February 2013 election, Grillo campaigned on an anti-European platform, even promising to hold a referendum on whether Italy should remain in the currency union. Mario Monti, the outgoing prime minister, appointed to head an interim 'technocratic' government in November 2011, campaigned as a pro-European and received an electoral drubbing.

Pier Luigi Bersani, head of the center-left Partito Democratico (PD), also promised a pro-European Italian government, and his party received 29% of the votes, down from 38% in the 2008 election.

Although the PD did manage to lead a coalition government, it ran through two prime ministers – Enrico Letta and Matteo Renzi – before settling on Paolo Gentiloni. The damage was done. The jockeying for power within the PD, much of it instigated by Renzi, eroded the party's reputation and public standing. In the March 2018 election, the PD received 19% of the votes cast. In contrast, the Five Star Movement increased its vote share to 32%. The anti-Europe parties altogether received about half the votes; if former Prime Minister Silvio Berlusconi's Forza Italia, with its softer European-skepticism, is added, nearly two-thirds of all Italians distanced themselves from Europe in the latest election.

Thus, in Germany, AfD has attracted economically anxious Germans worried that the German government is doing too much for Europe. In Italy, the Five Star Movement has gained because anxious Italians are angry that the European governance system disadvantages, and even damages, their futures. Despite the continued decline in nominal interest rates under the ECB's quantitative easing programme since January 2015, the real interest rate for Italians remains higher than 1%; in contrast, the real interest rate for Germans is -1%, which gives German producers and consumers greater ability to spend and grow. The single monetary policy continues to feed the economic divergence between northern and southern member states, which sustains and amplifies the political divisions.

Today many hope that, spurred by French President Emmanuel Macron's call for euro area reform, Merkel will work on repairing the euro area's architecture. Such a hope is illusory. Merkel is all too aware that any sign of financial generosity toward Europe will embolden the rebels within the CDU. Other northern nations have made clear that they will oppose calls on their taxpayers (Rutte 2018, Finance Ministers 2018). No euro area nation state is willing to cede its national parliament's sovereignty on fiscal matters. Policy decisions will remain disengaged from politics. Hence, even if new financial arrangements are engineered, it will be impossible to achieve accountability in euro area governance. Political tensions will continue to build.

## Concluding remarks

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There are no easy answers to Europe's economic and political woes. For this reason, as I argue in my forthcoming book, the answers will not be found in 'more Europe'. For too long, euro area leaders have dismissed or denigrated the domestic public rebellions. This is a terrible mistake. However inchoate, and sometimes nationalistic and xenophobic, these rebellions have been, they convey an important message. In addition to the distress the euro directly inflicts, the single currency distracts European leaders' attention from where it ought to be directed: domestic priorities. Of special importance is strengthening human capital, a capability in which all southern euro area countries (and even some northern countries) are lagging behind world leaders. Investment in human capital is crucial to achieving greater equity and sense of fairness while helping to regain international competitiveness.

Put simply, European leaders must shift their efforts away from the ultimately impossible

goal of making euro area governance more accountable and towards national domestic economic agendas that give hope to those who feel disenfranchised. If they fail to make this shift, domestic politics will continue to fragment, and as that happens, European politics will become ever more corrosive.

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