Rebuilding the Eurozone: Germany's Role (ARI)

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Theme: The European Economic and Monetary Union (EMU) is revamping its regulatory and operating framework in the wake of the crises affecting various member states. The initiative led by the German government is important, and hotly debated.

Summary: This analysis presents an overview of Germany's position in the debate concerning the reform of economic governance in the Eurozone. The work begins by reviewing the regulatory and operating framework originally imposed by the European Economic and Monetary Union (EMU) on its members and the main reason why it was not efficient in preventing the recent national crises. The German authorities were supporters of this framework and are currently leading the initiative to propose new internal pacts that ensure the definitive financial solidity of the Eurozone. There is intense debate, both inside Germany itself and in other member states, since the process involves bringing together very different political positions.

Analysis:

Introduction

The crisis has required strong financial support measures, but in particular it has revealed the deficiencies of the Stability and Growth Pact (the Pact) in terms of either controlling disorderly budget processes or tackling economic disruption originating in the private sector. The scale of the problems explains why the reactions within the European Union were not very coherent initially, but during 2010, the country with the greatest weighting, namely Germany, defined its political position and acted to shore up the Union and support its members. As well as the measures already implemented in the cases of Greece and Ireland, negotiations are underway to define a systematic framework to tackle the problems uncovered by the crisis and to strengthen the commitments undertaken by member states in light of the proposal of a permanent rescue mechanism from 2013. There is talk of a system of governance for the Eurozone economy and of a competitiveness pact. The agenda for these talks is complex and very different interests must be reconciled. Obviously, an overall vision is needed. The German government, amid a flurry of criticism that equated its slowness to act with disinterest, hopes to complete the talks in March 2011.

For now, the European Economic and Monetary Union (EMU) is unlikely to achieve anything other than practical solutions, with little chance of deep-rooted transformation in the legal-political structure of the Union or significant concessions with regard to sovereignty. Progress towards fiscal federalism models may meet resistance in Germany's Constitutional Court and perhaps in some other capitals that have not yet expressed their view. Spain will likely be able to support a new more coherent framework

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for EMU, introducing mechanisms to verify policies against obligations undertaken and accelerating its real convergence with the more advanced countries. In its own interests, Spain should introduce mechanisms to verify its policies against the obligations it has undertaken in the Union and, now that it has finally embarked on a serious programme of structural reforms, it should reflect as soon as possible on which sustainable growth model would enable it to close the structural gap on the most advanced EMU countries.

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German Caution

European integration was not the work of theoretical visionaries, but of realistic politicians. It has taken a highly practical route, leaving scope for successive achievements, to be assimilated by member states sometimes at an exasperatingly slow pace and to acquire sufficient maturity. But it has also experienced periods of unbridled enthusiasm, in which impatient politicians have preferred to overlook the importance of gradual consolidation and instead speed up objectives whose compliance required still-complex institutional adaptations. It might be argued, following Zatlin and other historians, that the monetary union has been one of the latter cases (though certainly not the only one). Perhaps this is why EMU was launched within a regulatory and operating framework, the Stability and Growth Pact, that was unquestionably deficient.

The project of monetary union was open to countries of the EU whose economic structures were highly diverse. According to economic literature of the 1960s, in particular the work of Mundell, a monetary area can scarcely be ‘optimal’ (ie, ‘feasible’) in such conditions, because the limits of tolerance to tensions imposed by the discipline of a single currency would be very different in heterogeneous economies. For years, this reflection inspired the German caution in respect of the project. It was obvious that German public opinion would never agree to getting rid of a stable and solid currency if the project could entail the risks of fiscal and monetary disorder which for many years had characterised the economic policies of France and Italy, not to mention countries like Spain and Portugal, which initially did not even appear to be candidates with possibilities. Consequently, Chancellor Kohl made his agreement conditional upon the creation of a European Central Bank in the likeness of the Bundesbank, and upon compliance with a series of economic policy criteria, first during the access phase and later during the project’s lifetime. Furthermore, it was thought that monetary stability and the increase in intra-EMU trade flows would bring significant improvements in productivity in the weaker economies and would therefore boost their process of real convergence (it is hardly necessary to highlight how ill-founded that optimism was).

The so-called ‘convergence’ criteria are well known and it is sufficient for our present purposes to recall the 3% deficit limit and the 60% external public debt cap. Two observations seem worth making here.

First, the economic research had emphasised the structural differences or similarities between the economies interested in joining the monetary area, yet the 'convergence' mentioned in Maastricht and the Pact is not structural, but proposes only to standardise critical economic data of the member countries (which explains why, for instance, unemployment is not one of the criteria). The weakest candidates to join EMU made huge efforts to meet the entry conditions and agreed to submit their national growth policies to a supranational monetary framework and limiting fiscal criteria. Belonging to EMU would make it possible to share a proved economic stability policy for countries that for years had played obliviously with inflation and devaluations. In political and economic terms, this is an extraordinary benefit. But it only goes so far, because, in contrast, belonging to the single currency did not make it especially easier to close the gap between economic structures. The weaker economies have to identify their own route for economic growth. French pressure to change the Pact's name, adding 'Growth' to 'Stability', was merely cosmetic and left the basic philosophy of the Pact completely intact.

Secondly, surrendering to (amply justified) German fears of the fiscal excesses of some candidates, the Pact did not take into account the possibility that budget deficit and growing debt might be a consequence of economic crises triggered by the excesses of private-sector investors (or unpredictable external shocks such as a global financial crash). The academic debate, at the time, focused on the mechanical aspects of the Pact, ascertaining, for example, that a debt of 60% is sustainable with recurring deficits of 3% provided that the economy is growing at a nominal 5%. The criticism of the principles involved is much more recent, although any macroeconomic text would have highlighted the considerable weakness of the Pact which has been made evident in this crisis. The question is as follows: an economy's current account balance is equal to the sum of the private savings/investment and public-sector spending/revenue balances. Accordingly, a public deficit of, say, 4%, may be over-compensated by a private sector surplus of, say, 9%, generating an external surplus. Based on these fiscal data, the Pact would activate the excessive deficit procedure, but any analyst would interpret the public deficit in the much broader context of a net saving economy with a positive current account balance. And the opposite is also true: although public accounts might be orderly, the private sector could be unwinding savings and incurring a sizeable external debt. The negative current account balance will reflect this difference in performance, but the Pact's warning systems would not be triggered despite the serious macro-economic threat posed to the country. That is what happened with Spain and Ireland's property-market bubbles: neither of the two countries had breached the 3% deficit criterion since the Eurozone's creation in 1999. However, the Pact's alarm sensors were set to detect excesses in the public sector, so they were not triggered by the accumulation of deficits and external financing in a private sector that was immersed in a euphoric frenzy of investment. In other areas the Pact has also shown critical operating weaknesses. For example, it was not sensitive enough to deal with the manipulation of figures in a country such as Greece, whose track record in the EMU abounded with almost systematic breaches of the 3% criterion.

Breaches of the Pact

There is nothing new about breaches of the Pact. It was openly breached when France and Germany closed their public accounts with deficits of more than 3% between 2002 and 2005. This was a very unsavoury episode, because the largest two countries in the EMU managed to force through amendments to the Pact instead of submitting to the penalty procedure in place. The European Commission itself acted very responsibly, filing an appeal –that was ultimately rejected– against the Council's decision.

In any event, admittedly the French and German deficits did not send out any major shock waves to the broader EMU economy. Now, in contrast, the bursting of the property bubbles in Spain and Ireland, Portugal's government deficit and the persistent and manipulated deficits in Greece, have had spill-over effects and have violently shaken cohesion within the EMU. All the countries have seen their ratings downgraded in financial markets and have endured massive fluctuations in their risk premiums. Governments and banks have faced difficulties securing funding, to varying degrees, and sovereign insolvency risk in Eurozone countries has loomed in financial circles.

Harassed from Several Sides

European politicians did not expect to have to tackle an avalanche of events that would bring the Pact's deficiencies firmly into the spotlight. The first major crisis in the Eurozone was triggered largely by factors which the Pact had completely overlooked. Basel data reveal the significant weighting of Greek and Spanish debt at German and French banks, British and German exposure to Irish banking liabilities and Spanish banks' exposure to Portugal. If the variable taken into account had been a country's debt trend, instead of an obsessive partial figure such as budget balances, the crisis would probably have been nipped in the bud.

Furthermore, the Treaty's so-called 'no-bailout' clause (Article 125) excluded aid to the affected countries and effectively compelled a questionable legal basis to be artificially defined outside the EMU framework. It seems clear that the Eurozone had been set up without a safety net to tackle serious national disruptions or overflow effects on the rest of the system.

And finally, the 'market' has taken on a disconcertingly pivotal role, due largely to the interaction of two dangerous spirals. Its negative perceptions, which are the reflection of more or less well-thought-out analyst and media opinions, come back to influence the same analysts and media, thereby confirming and spreading the shoots of scepticism. Furthermore, the market's hypersensitivity to comments on the austerity programmes, however superficial, readily triggers erratic movements in countries' risk premiums, compromising their access to funding and ultimately jeopardising the programmes' chances of success. Having said that, it is worth highlighting that the market does play a vital role in subjecting political decisions to an unyielding test of credibility: the diatribes aimed by distinguished European political personalities against 'speculators' were clear evidence of their discomfort with market logic.

German Leadership: the Good and the Bad

Against this backdrop, it has been necessary to improvise, creating out of nothing structures of immediate support for the most struggling countries and tackling the reform of the current regulatory and operating framework. That is why it seems unfair to level such bitter criticism of the undeniable blunders and procrastination that have been evident throughout 2010 in the Commission, European politicians and, in particular, the German authorities. But the biggest EMU economy has finally taken responsibility for maintaining the cohesion of the Eurozone. Germany's leadership has been, and still is, pivotal. With good political sense, it has also maintained the traditional model of Franco-German cooperation, despite Paris being in very much a supporting actor's role, and the leaders of the two countries being far from having the personal rapport which Kohl and Mitterrand enjoyed.

Chancellor Merkel and her Finance Minister, Wolfgang Schäuble, have been key figures. It is true that the scale of the problem overwhelmed them for some months, and they had little support from public opinion whose confidence in the single currency has not exceeded 20%-22% for years, and whose backing of the CDU (for other reasons) dropped sharply throughout most of 2010. However, their own reactions were poorly articulated, they were uncoordinated and they were sometimes imbued with the kind of wealthy country's arrogance that were not exactly conducive to finding conciliatory formulae, such as when Schäuble (whose excellent record as a public servant is tarnished by unfortunate gaffes) talked in March 2010 of the possible exclusion of Eurozone members, or when Merkel herself advocated automatic penalties for countries that failed to meet their commitments.

Once the early indecision was over, the German government actively contributed to affirming the political will that secured the support package for Greece (May 2010) and paved the way for the constitution of the European Financial Stability Fund (EFSF), whose initial application (November 2010) was in the burdensome operation to bail out the Irish economy, once its final bank rescue figures were known. Many media did not hesitate to call this operation a ‘German imposition’: in Ireland there was talk of ‘German dictates’ and ‘national humiliation’, in an attempt to ignore the overwhelming scale of a national crisis the burden of which EMU and, to a considerable extent, Germany, were about to share, logically under certain conditions. Since the end of 2010, Germany’s commitment to the Eurozone has been expressed in no uncertain terms. In the Bundestag, Chancellor Merkel unequivocally said that ‘no-one would be allowed to fall in Europe’ and she listed the nine points which, in her view, must be adhered to in managing this and any similar future crises. It is interesting to highlight that all parties, except The Left (*Die Linke*), expressed their support, and even went further than that, as in the case of the E-bond. Merkel has often repeated the phrase that ‘if the euro fails, it is Europe that fails’. The planned new rules for the EU, presented as a Franco-German project, are already on the table. ‘Whatever scepticism one might have had’, said a senior executive of a major international bank in December, ‘one cannot doubt (Germany’s) political commitment to the European project’.

However, one thing is the political will to redirect the situation, and quite another the huge technical and political difficulty of structuring a regulatory and operating framework that guarantees the consistency which the current one lacks. Critics of Germany's attitude make little effort to distinguish between these two aspects and it is therefore worth making an effort to clarify this.

Underlying Themes vs. Negotiating Techniques

The EFSF’s capacity is likely to prove insufficient to tackle another joint effort in Greece or any other national crisis affecting larger economies. It must raise funds by issuing bonds (up to €440 billion) whose triple-A rating depends on the guarantees of member countries and the blocking of a not insignificant part of each issue. The European agenda features options to raise the cap and use the amount available, for example, to acquire bonds and ease the ECB’s balance sheet, or to help the country to buy back its own debt. The debate is ongoing, although agreement is unlikely to be reached separately, but as part of the broader reform of the mechanisms of possible ‘economic governance’ which (schematically) must strike a delicate political balance between self-control commitments in some countries and solidarity commitments by the strongest economies. It seems imperative that the obligation of solidarity should be on an equal footing with the obligation to manage prudently: no mechanism will benefit the Eurozone if it stimulates moral hazard by offering quasi-automatic aid to correct the results of wayward policies. This explains the German authorities' insistence –as the country which, when the time comes, would be asked to contribute the most funds– that the multiple matters on this agenda are not dealt with separately but negotiated as a coherent block, avoiding 'slicing up' the process and losing sight of its unitary perspective. Schäuble's technique is well-known to any good negotiator: agree that 'we will only have an agreement when we have agreed everything'.

However, many media repeatedly associate the lack of tangible progress in isolated matters to dilatory or negative tactics by the German government, ignoring that EMU is facing global restructuring and not merely dealing with a disorderly list of individual items. For example, markets expressed their dissatisfaction with the result of the Ecofin meeting on 17-18 January, presumably because a number of sources had on no sound basis raised expectations of an agreement. The analysts' scepticism is reignited every time qualified commentators, in particular prestigious US economists, shrug off the political economy of the process and augur a fatal end to EMU's efforts to survive which, at least for now, reflect none other than the difficulties and tensions that are typical of any complex negotiating process. Just one example is the disdainful comment by Kenneth Rogoff (at Davos): 'if they're not willing just to write blank checks to the peripheral countries, I don't see what their strategy is'. It is not the first example, and neither, probably, will it be the last.

Underlying Themes vs. Constitutional Legality

Many opinions emphasise that Merkel trod carefully in fear of the German Constitutional Court (BVerG). Here it is necessary to digress somewhat. Whether it is called 'fear' or otherwise, the Chancellor's attitude is irreproachable. That the executive power should aspire to legal stability in its actions and therefore evaluate their legality in accordance with constitutional case law before acting, is an indication of respect for democratic processes, in Germany or anywhere else. Merkel knows very well that Germany's involvement in European initiatives (such as the Treaties of Maastricht and Lisbon, the Greek bailout package and the EFSF) have been closely scrutinised by the high court, since the transfer of competences to a European intergovernmental structure that lacks democratic legitimacy must be reconciled with specific rules under the German constitution which declare 'untouchable' the basic principles –'the core constitutional identity' of the German State– provided in its Articles 1 (human rights) and, in particular, 20 (federal, democratic and social state).

The ruling on Maastricht (1992) was conceptually very open. The transfer of sovereign powers must be limited in accordance with the level of democratic legitimacy of the EU at each given time. The court considered that the powers already transferred defined a restricted sphere of action for the EU, which under the principles of subsidiarity and proportionality could be reconciled with the fundamental law. Neither should the multiple cooperation policies within the EU pose a problem, since they are developed between states and do not imply a broadening of the Union's powers. The ruling on Lisbon went further (in a strong and highly restrictive tone and wording) because it appeared to set absolute limits to the transfer of powers: the BVerG distinguishes between the transfer of limited powers and the transfer of a state's sovereignty. The scope of this doctrine will require future clarification, but for now the court has constituted itself as the decisive institution to interpret in each case whether the powers transferred by the German government, or exercised by EU bodies, uphold the wording and spirit of the constitution. The court declares that in no case may competence to decide on its own competence be transferred to the EU (the principle known as *Kompetenz-Kompetenz*) and it reserves the prerogative to serve the government in Berlin, in the event, with a 'non-compliance order' in respect of an EU act. Many experts believe that the focus of this ruling will make it very difficult for any German government to participate in future European projects that require further 'sizeable' transfers of competences. Transfers in tax or budget matters to federal EU structures could be particularly exposed. In contrast, the following year the court ruled on a labour-related theme, the so-called 'Mangold case' (2010), recognising, unreservedly except for one judge's dissenting vote, the precedence of the EU law over a German legal regulation.

A Case: the Issuing Agency of E-bonds

This uncertain interpretative line raises questions for the future. One important example would be the possible unified issuance of E-bonds by members of EMU via a specialist agency. Countries with triple-A ratings would provide the necessary guarantee for the issues to obtain the maximum rating. The political significance of this possible project cannot be overstated. No member country would be individually exposed to the market, so that country risk premium would disappear and with it the problems in accessing funding and its cost. The mechanism would remove the current debt market fragmentation, making any fiscal crisis of a member country solely a matter of intra-EMU policy and it would create a major market for public debt probably comparable to that of the US, catapulting the euro's international role. In short, it would give the EMU the stability in respect of the market which it has lacked throughout this crisis.

The difference with the current EFSF (for now in place until 2013) is huge. The agency needs a much more robust structure to deserve the market's confidence: for example, incorporation into the institutional framework of the EMU (recall that the EFSF is not even an EU mechanism, but an agreement between member countries), a firm legal basis as an alternative to Article 125 of the Treaty and sufficient decision-making autonomy, both to issue and to negotiate the channelling of funds to countries. Although the agency's capacities may be calibrated differently, it is hard to imagine how it could be fast-tracked through the simplified channel of Article 48.6, in other words, without state competences being transferred to it. The IMF is probably right to say that the project would be an 'embryo of fiscal federalism' ('Euro Area Policies: Selected Issues', on Art. IV of the Eurozone, 2010). The agency is almost certain to require a reform of the Treaty. If some German citizens were doubtful as to the constitutionality of an instrument such as the EFSF, they will find even more reasons, in light of the arguments of the Lisbon doctrine, to harbour doubts with regard to an agency with supranational powers.

That is why it is understandable that Merkel and Schäuble have preferred not to battle against the scepticism which is brewing within their own party, even though the E-bond does have the support of responsible media, of experts like Peter Bofinger (one of the five *Wirtschaftsweisen*, or Wise Men, who advise the government) or of influential socialist opposition politicians, like Peer Steinbrück, Frank-Walter Steinmeier and Martin Schulz. But nothing would do more to harm the Eurozone than an inter-governmental agreement to create the agency that was immediately declared unconstitutional in Germany. For now, it is more advisable to act with prudent realism. In any event, it is somewhat less understandable that it should be European politicians who pressure for such an ambitious project but one that is so vulnerable to a test of constitutional legality. The current government of Luxembourg, the Italian Finance Minister and one of Spain's former Prime Ministers would do well to ease their federalist *desiderata*. The IMF (*ibid*.) adopts a wholly realistic view on what is desirable and what is achievable. A pragmatic EMU may for now limit itself to specific but reasonably feasible achievements, which by the way are far from simple, that underpin the *de facto* solidarity and lay the groundwork for future integrating projects: this is advancing once more towards Europe, step by step, as Schuman and Monet advocated. Correcting the deficient current framework for the single currency might only be the second best option, but it could start imposing the rules of conduct and an orderly mechanism for managing crises now.

Inapplicable Theories: the Distribution of Burdens
As Juergen Donges recalled recently, Paul Krugman and other US economists have highlighted that an expansionist policy in Germany, which might be called 'internal revaluation', could mitigate the impact of the tough austerity policies (or 'internal devaluation') of struggling countries. If Germany accepted the burden of part of the European readjustment it is obvious that the economic and social costs would be redistributed in a more weighted manner. This exhortation is put forward by quite a few European analysts and politicians, including the current Managing Director of the IMF. Theoretically sound, its proponents know only too well that this kind of cooperation has been the preserve of text books and it is very difficult to 'sell' to public opinion. Under the guise of a reasonable distribution of the burdens, the costs for each country would not be proportionate: the country that has submitted to serious economic discipline is expected to share the sacrifice of introducing a similar discipline in other countries that had previously rejected it. It should be recalled that Keynes tried to introduce the responsibility of countries with surpluses in the post-war monetary order –at that time the US–, but the US negotiators refused outright, convinced that Congress would never adopt a decision taken by an international body, in this case the Clearing Union proposed by the UK. The nature of the problem was the same, although at the time it was not about reforming vs. reluctant countries, but about a powerful economy vs. others that were ravaged by war. A poor alternative, the 'scarce currency' clause, was a dead letter in the IMF articles of agreement (and there it remains, in Article VII). The Cold War put an end to these concerns, because the US, so resistant to international pressures to share the costs of readjustment, did not, however, hesitate to export massive amounts of capital via the Marshall Plan when it considered it to be essential to consolidate the economies and security of Europe with respect to the USSR. Years later, Japan resisted any adjustment that would reduce its trade balance with the US, just as China is doing today. Barry Eichengreen, historian of the international monetary system, provides many more examples.

Conclusion: It is not possible to maintain the integrity of the Eurozone without the active involvement of its most powerful country: Germany. Criticisms of any leading country are par for the course and in general not very constructive: France was the favourite target of similar invective for many years. In the Anglo-American world, where the survival of the euro is regarded with suspicion (for the US it means a cohesive Europe vs. an invertebrate Europe, and for the UK a likely financial axis between Paris and Frankfurt, at London's expense), this kind of criticism, sometimes stark and sometimes more subtle, is systematic. However, there has been no shortage of superficial improvisation within EMU itself regarding Germany's role in this crisis. Ireland is one example, especially in November 2010, and similar comments can be commonly heard or read in Spain.

From the practical standpoint, I think the reforms underway are being correctly channelled. The internal debate set in motion at the 4 February summit is merely the start of a negotiating process which, judging by some initial reactions to the package of proposals presented by Germany and France, looks set to be very tough. The next step is for the president of the EU to pinpoint areas of consensus that permit successive advances and perhaps the completion of negotiations at the March summit. Whether it is then or later, the survival of the Eurozone as we know it is at stake.

Spain should not find it difficult to take part in the agreement that is likely to be adopted. Our problems are internal.

In the first place, it is worth recalling that membership of a powerful economic area in which currency exchange risk is eliminated is invaluable for a business sector which, like Spain's, does much of its external trading within EMU. But access to this formidable advantage was a one-off event in 1999. No-one remembers that moment now. Having the euro now seems to us like a given right. There is an obvious error of perspective here. All members of a monetary union necessarily undertake rigorous obligations of conduct. This notion was buried during the years in which the property boom created the false impression that Spain had found its own formula for economic success. The main lesson for Spaniards is that the country cannot put its solvency at risk ever again, either by standing by and watching costs erode its competitiveness, or by executing disorderly public policies, or by allowing episodes of excess private investment whose tumultuous culmination may be a recession and grave fiscal disorder.

Secondly, the new EMU framework should be a strict benchmark for our internal policy. Economic management is badly in need of systematic public debate from all angles (government policy, parliamentary criticism, media coverage) taking into account Spain's responsibility as an important member of a monetary union and the dangers, for us and for EMU, of following different policies. If entry into EMU was a one-off event, staying there requires ongoing coherence between policies and their regulatory framework, day after day. None of this should be confused with submission to other countries or absurd notions of 'homework' set by Berlin or Brussels: the basis of political will to continue using one of the world's strongest currencies as our own is not to pay lip service to anyone, but is in our own national interest.

And finally, the future problem is the same problem we began with: the lack of real convergence with the most advanced countries. It is trivial to recall that, to close the gap, Spain must grow regularly at rates higher than the EMU average, but it must do so with stability, under the limitations of fiscal and monetary policy that apply in the Union and without compromising price-competitiveness. At present, there are enough positive elements to project a medium-term growth model based on rigorous policies (in which there is no room for procrastination or U-turns): a tough austerity programme, sweeping structural reforms and a restructuring of the savings bank system. The key role of growth driver must be reserved for private initiative and, in particular the more dynamic export sector. It is essential not to make more mistakes and to identify a sustainable model this time, one that is incompatible with mirages of prosperity that irradiate from speculative investment processes. The debate on growth in Spain cannot wait, not even in a pre-election year.

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