



## The Political Economy of Germany in the Sovereign Debt Crisis

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### 1. The German Economic Situation

#### *Economic Growth Perspectives and Employment*

After the downturn in 2008–09, there has been a strong economic recovery in Germany in 2010 and the first half of 2011. But in the context of an economic deceleration expected for the OECD countries, also the German economy will probably slow down considerably in the second half of 2011 and in 2012. Export growth is likely to weaken as key export markets cool down, partly due to fiscal tightening in Germany's main trading partners. Export growth scored a high 14.4 percent in 2010 and is likely to decelerate to 8 percent in 2011, as a consequence of fiscal tightening and the flattening of the stock cycle in most major markets.

Meanwhile, import growth is expected to decrease from 12.8 percent in 2010 to a still strong 6.6 percent in 2011. Domestic demand is also expected to decline as consumers and business are becoming more cautious. Private consumption growth is forecast to accelerate to 1.6 percent in 2011 from 0.4 percent in 2010, but will then stay at around 1.4 percent on average in 2012 to 2015. Employment is expected to expand which will support domestic demand, but real wages are expected to grow only slowly. Government consumption is likely to grow only moderately given self-imposed austerity and the soon-to-function debt brake. But around the general elections (presumably in September 2013), public spending may temporarily be increased.

Forecasts see growth to slow to 2.9 percent in 2011, 1.4 percent in 2012 and an average of 2 percent for the period from 2013 to 2015.<sup>1</sup> But these assumptions do not take into account scenarios of a deterioration of the euro area debt crisis and particular the evolution of a banking crisis, or even a break-up of the currency. Hence, there are considerable downside risks for the German economy.

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<sup>1</sup> Country Report Germany, Economist Intelligence Unit, September 2011.

### ***Inflation and Exchange Rate Developments***

Forecasts see relatively strong inflation in 2012/2013. Inflation in Germany reached a low average of 1.1 percent in 2010, but may reach 2.3 percent as capacity constraints increase and wage growth accelerates moderately in a tightening labour market. Inflation is expected to average about 1.8 percent during in the period from 2012 to 2015.

The euro is likely to display considerable volatility. Interest-rate differentials are continuing to support the euro. But investors will remain concerned about the ongoing debt, banking and governance crisis and about the developments in the region's periphery, so downward pressure could occur. This would fuel German exports. Sharp movements into the other direction meanwhile would probably be supported more easily by Germany than by many other euro area member states including France, given Germany's high degree of competitiveness.

### ***Current Account Developments***

Germany's current account surplus is expected to fall moderately from 5.7 percent of GDP in 2010 to 4.1 percent in 2011 and could stabilise around 3 percent of GDP in the period 2013 to 2015. Germany's large trade surplus makes it vulnerable to a possible slowdown in major trading partners, in the euro area and also in Asian and the US market. For the debate about macro-economic imbalances in the euro area, the reduction of Germany's surplus may reduce political tensions in a period in which the new mechanisms for economic policy coordination (part of the legislative "six pack" that installs an enhanced mechanism for macro-economic policy coordination) will run their first test in 2012.

### ***Budgetary and Economic Policy Priorities***

One important priority of the current government is to (nearly) eliminate the fiscal deficit over the next four years. The government focuses on consolidation of the public finances, with the aim of moving to budget balance in the medium term. After a deficit of 3.3 percent of GDP in 2010, the general government deficit may narrow to 1.7 percent of GDP in 2011 and to be almost in balance by 2015. The government's 2012 budget and 2013 to 2015 financial plans foresee gradual declines in the federal budget deficit, based mainly on slow expenditure growth and strong revenue expansion owing to the economic upswing. Meanwhile, public and political support for good public services, with priority given to education and research, is invariably high.

Upon the pressure of the liberal coalition partner FDP, the government has agreed in principle to a modest tax cut for the election year 2013, but there seems to be a strong will in the CDU-led Finance Ministry not to allow this to worsen the public finances materially. In August 2009, Germany introduced a debt brake which—if respected—will impose tight constraints on the federal and the Länder level. Within the euro area, the German government seems to be determined to make others follow its own example (see the discussion on governance reform below), not only by pushing governments towards austerity but also by driving the debate on domestic fiscal rules and national debt brakes in the euro area.

### **Germany's Debt Brake**

The debt brake limits the countries possibility to run cyclically adjusted deficits (structural deficits) at the federal (Bund) as well as the state (Länder) level. Changes to the constitution were necessary for the debt brake to come into force. Thus the Bundestag as well as the Bundesrat had to pass the legislation. The debt brake provides guidelines for the reduction of the budget deficits since 2011. Its focus is on the cyclically adjusted budget to allow for automatic stabilizers to work. The 0.35 percent of GDP limit for the annual federal cyclically adjusted budget will become binding in 2016 and the states won't be allowed to run any deficits from 2020 onwards. Catastrophes such as floodings etc. and deep recessions are exceptions to this rule.

The second major concern is to stabilise **the financial sector** after the 2008 crisis and at a time when it may face further losses. The weakness of some German banks will remain a major issue, particularly given their exposure to the euro zone sovereign debt crisis. Renewed restructuring could well make additional state support necessary, especially given the need for higher capital ratios under the Basel III agreements at the same time.

Reform of financial sector regulation is under way: a key element was a law of November 2010 to provide a method for tackling the possible insolvency of systemically important banks. A bank levy to finance a €70bn fund to support the German financial sector in future crises has also been introduced.

## **2. The Political Situation in Germany**

### *Composition of Parliament, Government and Voters' Support*

Since autumn 2009, Germany is governed by a coalition composed of the centre-right Christian Democratic Union (CDU), its Bavarian sister party the Christian Social Union (CSU) and the Free Democratic Party (FDP).

**Table 1 Composition of the current federal government in October 2011**

<b>CDU/CSU</b>	<b>FDP</b>
Chancellor: Angela Merkel	Federal Minister of Economics and Technology, Deputy Federal Chancellor: Philipp Rösler
Federal Minister of the Interior: Hans-Peter Friedrich	Federal Minister for Foreign Affairs: Guido Westerwelle
Federal Minister of Finance: Wolfgang Schäuble	Federal Minister of Justice: Sabine Leutheusser-Schnarrenberger
Federal Minister for Labor and Social Affairs: Ursula von der Leyen	Federal Minister of Health: Daniel Bahr
Federal Minister of Food, Agriculture and Consumer Protection: Ilse Aigner	Federal Minister for Economic Cooperation and Development: Dirk Niebel
Federal Minister of Defence: Thomas de Maizière	
Federal Minister of Family Affairs, Senior Citizens, Women and Youth: Kristina Schröder	
Federal Minister of Transport, Building and Urban Affairs: Peter Ramsauer	
Federal Minister for the Environment, Nature	

Conservation and Nuclear Safety: Norbert Röttgen	
Federal Minister of Education and Research: Annette Schavan	
Head of the Federal Chancellery and Federal Minister for Special Tasks: Ronald Pofalla	

Together, the coalition partners hold a rather comfortable majority of 330 seats (237 CDU/CSU and 93 FDP) of the 620 seats in the Bundestag, Germany's lower house.

**Table 2 Election results, seats in Parliament and current voters' intentions**

Party	Seats in Parliament	Electoral results 2009 (percent)	Voters' intentions if general elections were held now <sup>2</sup> (percent)
CDU/CSU	237	33.8	35
SPD	146	23.0	28
FDP	93	14.6	4
Linke	76	11.9	7
Grüne	68	10.7	20

Since the first decisions over the rescue packages in the course of the current debt crisis, there have been severe tensions within the coalition over the way to cope with the sovereign debt crisis. Moreover, the government has been weakened by defeats in regional elections and with regard to public opinion data. There is today a large distrust in German government: 66 percent believe that the German federal government has lost track with regard to the crisis. A similar percentage of people (65 percent) think that the federal government did not take the correct decisions in the Euro and debt crisis (ARD-Deutschland-Trend September 2011).

Despite the tensions and the decline of support, the next general elections are not likely to be advanced, in particular because the junior coalition partner FDP would risk not making it over the 5 percent threshold (see voters' intentions in Table 2 above). Before the next general elections, one more regional election is coming up: Schleswig-Holstein on May 6, 2012.

The weak performance of the governing CDU/CSU-FDP coalition in regional elections in the years 2010/2011 has had three major implications. Firstly, the governing coalition is in the minority in the upper house, the Bundesrat, which comprises representatives of regional governments. The coalition must therefore compromise with the opposition on laws that require ratification by the Bundesrat. Secondly, the CDU party leader, Angela Merkel, is seen as weakened, although she does not face a serious challenger at present. The FDP leadership has changed from Guido Westerwelle (Germany's foreign minister) to Philipp Rösler (now Minister of the Economy). Meanwhile, the party is running an increasingly critical campaign on the rescue measures agreed during the debt crisis (see below). In the Berlin elections, the FDP campaigned against euro bonds. Recently, there were rumours that Parliamentarians within the FDP Parliamentary group could actually push the FDP towards an inner-party referendum on Germany's participation in the debt crisis resolution mechanisms. Such a move could actually cause a break-up of the coalition if the

<sup>2</sup> Source: ARD-Deutschland-Trend September 2011, <http://www.infratest-dimap.de/umfragen-analysen/bundesweit/ard-deutschlandtrend/2011/september/>.

FDP leadership can then no longer follow support Merkel's crisis management strategy. But the bad results the FDP scored in the Berlin elections (1.9 percent of the votes which means it is no longer present in the regional Parliament) have not made this scenario very probable.

In the Bundestag's vote on the European Financial Stability Facility (EFSF) on September 29, 2011, the governing coalition agreed to the law with 315 votes, which means that the Chancellor had her own majority. Further tests coming up will be the Bundestag vote on the second rescue package for Greece scheduled for October/November 2011 and the vote on the future European Stability Mechanism (ESM) presumably coming up in early 2012.

### *Public Opinion in Germany*

German policy makers regularly refer to the state of public opinion in order to explain the red lines the government draws both in debt crisis management and in euro area governance reform. In fact, 1.5 years into the sovereign debt crisis, public opinion is critical, but not anti-European. But given German sensitivities when giving of the Deutschmark, this crisis is particularly delicate to handle.

Before the outbreak of the sovereign debt crisis, political leaders did not show regret for Germany's post-war currency, but on the contrary outlined its benefits, in particular when it came to the celebrations of the single currency's tenth anniversary in 2009. But even then, the broad public evaluated the Euro more critically. Since the outbreak of the sovereign debt crisis, this tendency has accelerated.

From 2001, the percentage of citizens that see disadvantages in the Euro climbed from 45 percent of the people polled to 63 percent in April 2010. Roughly a third of German citizens think that the Euro has more advantages than disadvantages, only 6 percent think both are balanced.<sup>3</sup>

But still: 63 percent of the Germans are in favor of "A European economic and monetary union with one single currency, the euro" (cf. EB 75, p. 63, Annex). 88 percent think that it is a matter of the German national interest to keep the euro stable (cf. ARD-DeutschlandTREND, December 2010).

In general, distrust into the European Union outweighs trust in German public opinion (55 percent compared to 35 percent) (cf. EB 75, p. 44, Public Opinion in the European Union).<sup>4</sup> As already stated above, trust in the German government likewise is impressive.

Overall, there is criticism of the role of the euro during the crisis: 40 percent of the Germans agree that "the euro has cushioned the effects of the economic crisis" (7 percent totally agree, 31 percent tend to agree) whereas 50 percent disagree (19 percent totally disagree, 33 percent tend to disagree) (cf. EB 75, p. 133, Annex).

As to countries, that do not have their public finances under control, Germans prefer strict rules: 56 percent are of the opinion that these countries should be excluded from the eurozone, 40 percent disagree to exclusion (cf. ARD-DeutschlandTREND, December 2010). 47 percent of the Germans think that the state of the Member States

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<sup>3</sup> ARD-DeutschlandTREND, April 2010, Infratest dimap.

<sup>4</sup> Standard Eurobarometer (EB) 75 (Fieldwork: May 2011), European Commission, [http://ec.europa.eu/public\\_opinion/archives/eb/eb75/eb75\\_en.htm](http://ec.europa.eu/public_opinion/archives/eb/eb75/eb75_en.htm).

finances is one of the (two) most important issues that the EU faces today (EU27 average: 22 percent) (cf. EB 75, p. 25, Public Opinion in the European Union).

But, possibly surprisingly to some, Germans are in favor of a stronger Europe: 64 percent wish that, in the future, European countries should develop more common policies and act together more strongly (cf. ARD-DeutschlandTREND September 2011). In comparison: According to EB 75, 93 percent of the Germans agree with the statement that “EU Member States should work together more in tackling the financial and economic crisis” (59 percent totally agree, 34 percent tend to agree) (cf. EB 75, p. 139, Annex). Large majorities among the Germans polled for the Eurobarometer actually support more integration. This includes:

- “A stronger coordination of economic policy among all the EU Member States” (82 percent of the Germans judge this proposal as effective in tackling the crisis)
- “A closer supervision by the EU when public money is used to rescue banks and financial institutions” (85 percent in favor)
- “A stronger coordination of economic and financial policies among the countries of the euro area” (83 percent in favor)
- “A closer supervision by the EU of the activities of large financial groups/most important international financial groups” (85 percent in favor)
- “A more important role for the Euro in regulating financial services” (75 percent in favor) (cf. EB 75, p. 20, Europeans, the European Union and the Crisis).

But concerning the enlargement of the Euro Rescue Package/EFSF, German public opinion is rather skeptical: 66 percent think that the German Federal Parliament should vote against the proposal (30 percent think that it should vote in favor of it) (ARD-DeutschlandTREND September 2011). And when it comes to the highly politicized issue of Eurobonds, a majority of 55 percent opposes German participation (compared to 35 percent in favor) (ARD-DeutschlandTREND September 2011). Ursula von der Leyen’s (CDU Labor minister) proposal of the “United States of Europe” is welcomed by 42 percent (compared to 53 percent against).

Overall, Germans have a rather pessimistic outlook on the near future: Despite the measures already taken, a large majority of Germans (80 percent) thinks that the worst part of the crisis is still to come; 76 percent worry about a negative effect on wealth caused by the crisis (ARD-DeutschlandTREND September 2011).

Inflation is a constant concern to the Germans. In February 2011, 61 percent of the German people believed that prices are rising stronger than in the years before (28 percent think that the development proceeds as usual) (ARD-DeutschlandTREND February 2011).<sup>5</sup> Fears of inflation were actually the major matter of concern in the first decade of EMU’s existence. Tabloids often nickname the Euro “Teuro”<sup>6</sup> reflecting the citizens’ sentiment that prices have risen strongly since its arrival. Inflation data for Germany contradicts this perception: from 1999 to 2010, German inflation has on average been 1.5 percent<sup>7</sup> (Euro area inflation was in line with the ECB’s inflation target of 2 percent on average from 1999 to 2010). German inflation ranged below the ECB’s target of 2 percent in all years since the

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<sup>5</sup> ARD-DeutschlandTREND, February 2011, Infratest dimap, <http://www.infratest-dimap.de/umfragen-analysen/bundesweit/ard-deutschlandtrend/2011/februar/>.

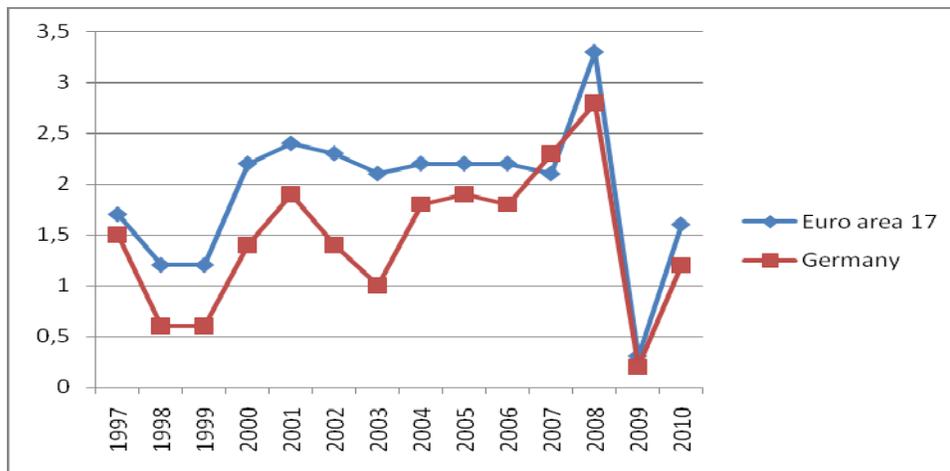
<sup>6</sup> “Teuro” plays with the words “Euro” and “teuer” (expensive).

<sup>7</sup> Own calculations based on Eurostat

<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=de&pcode=tsieb060>

start of EMU except for 2008 (2.8 percent) and underscored Euro area average in all years but 2007 (Germany 2.3 percent, euro area 2.1 percent).

**Figure 1: Annual average inflation rate euro area and Germany 1997-2010**



While price stability was a major issue in the citizens' perception and is likely to be so in the medium-term future, public opinion traditionally pays little attention to growth performance, for instance to the fact that the German economy for several years was among the weak performers in the Euro area with only Italy doing worse.

### 3. Germany in the Sovereign Debt Crisis Management

#### *Dragging the Feet on Helping the Others Out*

The German chancellor has made a commitment to do "whatever it takes" to support the euro. In doing this, the government has to maintain public support for the euro project, overcoming deep domestic resistance to Germany, in particular in the Parliament, assuming responsibility for other countries' debt. So far, German policy making during the debt crisis has prioritized political considerations over a fundamental solution.

Domestic and foreign observers paid a lot of attention to the fact that the German government did not act pro-actively on Greece in spring 2010 arguing it did not show a convincing commitment to the decision of the informal European Council of February 11, 2010 which promised help to member governments with problems to refinance their debt. In the view of many observers, this attitude increased nervousness in the financial markets and led to a deterioration of the crisis, for which the Parliamentary opposition has severely criticised the German chancellor.

A lack of political leadership has also opened ample room for irresponsible polarisation in the German tabloid press. With an unparalleled degree of hostility, Greek citizens have been depicted as lazy, corrupt, irresponsible, etc. While there were efforts by other media to draw a more realistic picture of the situation in Greece, at least for a few weeks the situation in the German media remained unbalanced.

There are probably three reasons why decision-makers in Berlin did not give earlier rescue promises to Athens. One concern was to exert as much public pressure on the Greek

government as possible in order to push and support Prime Minister Papandreou's reform agenda. The assumption that rescue packages create moral hazard problem (among policy makers) is very present in the German debate which is one of the reasons why the government requested high interest rates for credit given to the highly indebted countries.

The second concern was a hostile public opinion—and in particular no willingness to attempt to convince the public of Germany's self-interest to grant support as with North-Rhine-Westphalia, Germany's largest Land went to the polls on May 9th, 2010. The strongest concern was probably that a German participation in a rescue package, which could not be justified with the argument that the stability of the euro was at stake, could be challenged before the German Constitutional Court. Policymakers were deeply concerned by the scenario that a European rescue package could be ruled unconstitutional in Germany which was feared to cause substantial instabilities in financial markets.

### **Looking back 15 years: German fears and strategies to convince of the euro**

Many of the arguments (and emotions) developed in the course of the sovereign debt crisis management parallel those surrounding the introduction of the euro in 1999. At that time, Germany experienced an emotional debate on whether and under which conditions it should give up the Deutschmark. Looking back on the major arguments exchanged then provides important background to understanding the debate over Germany's involvement into the current management of the debt crisis and governance reform.

The Deutsch mark had become the symbol for the post-war *Wirtschaftswunder* and helped the country reemerge as a European and global player. The economic success, the stable currency and the related international recognition were among the few things Germans dared to show pride in after World War II.

In the 1990s, the debate over giving up the Deutschmark grew particularly intense when it became clear that the currency union would probably start with a rather large group of countries, including Italy, Spain and Portugal, the so-called "Club Med"<sup>8</sup>. Concerns about the future stability of the Euro revealed deeply rooted fears of a society which had lived through a hyperinflation in the early 20<sup>th</sup> century, the effects of which were a root cause for the emergence of the racist and belligerent Nazi regime.

The critics of the upcoming EMU were divided into two groups. While some opponents did not want EMU to happen at all, other critics, including the then-President of the Bundesbank, Hans Tietmeyer, argued for a political union to ensure that in particular national budgetary policies would not undermine monetary stability. In order to reassure an increasingly nervous public, the acting government underlined the strong degree of independence of the European Central Bank enshrined in its statutes which could only be changed by a unanimous decision of the member states, hence not against the will of the German government. By pushing through the Stability and Growth Pact in 1997, it hardened fiscal rules and the possibility to sanction member states in order to complement the Maastricht Treaty. Furthermore, it explained that the No-Bail-Out-Clause insured that no government would be liable to guarantee for public debt accumulated by other member states in the EMU. These provisions were not only relevant for the public debate, but also

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<sup>8</sup> In 1997, in Baden-Württemberg, the Social Democrat, Dietmar Spöri, (unsuccessfully) fought his electoral campaign to become regional Prime Minister with an anti-Euro-campaign.

the basis upon which the German Constitutional Court ruled that the Maastricht Treaty was compatible with German Basic law.<sup>9</sup>

### ***The German Debate of the Role of the ECB***

With market tensions spreading to Italy and Spain, the ECB was forced to take further unconventional measures in early August 2011. It firstly injected liquidity into money markets.<sup>10</sup> Second, the ECB resumed its securities markets programme (SMP) on August 8<sup>th</sup>, 2011, making significant purchases of Italian and Spanish bonds for the first time in a bid to lower yields (total SMP purchases were worth €110bn as of late August).

Such measures are particularly controversial in Germany, and with the Germans in the ECB's governing council. A major concern are the potential difficulties of "sterilising" large bond purchases and because of the impact on the ECB's balance sheet of any future sovereign debt restructuring. Officially, the ECB is expecting that the EFSF will assume responsibility for purchasing struggling euro zone countries' bonds from October 2011, but expanding the EFSF's volume to a sufficient scale will be politically and technically difficult. This hence implies a continued role for the ECB.

The German debate on the role of the ECB in crisis management, its independence and potential inflationary pressure in the euro area has peaked in August/September 2011. While the German Chancellor Angela Merkel silently backs the Central Bank's secondary market purchases, her former advisor and now Bundesbank President Jens Weidmann openly criticised the program—just like his predecessor Axel Weber who resigned from the Bundesbank in protest against the ECB's role in the sovereign debt crisis management and hence gave up the probable option of becoming the next President of the European Central Bank after Jean-Claude Trichet as of November 1, 2011.

The departure of Jürgen Stark on September 9, 2011 from his position of ECB Chief economist and one of six ECB board members, also in protest over the bond purchases, not only came at a critical point in time with regard to the evolution of the sovereign debt crisis. It also marks an important point in the German debate. The perception is now wide-spread that the original conception of the euro area built around Germany's stability-minded principles, hence the old Bundesbank-style currency union, seems to be coming to an end. Stark himself embodied the Bundesbank's stability orientation and represented important political and administrative continuity as former deputy President of the Bundesbank. It is probable that Stark, who has been rather outspoken even as ECB Board member, will continue to play an important role in the public debate. The opposition in Germany against the current approach to the management of the sovereign debt crisis is likely to gain momentum. The current government's euro defence policy is coming under increasing pressure, and the departure will maybe turn out to be another element weakening the German chancellor and her finance minister. They will hence be under fire from two sides, the "pro-European left" and the increasingly outspoken EMU sceptics.

### ***All Eyes on Germany: EFSF/ESM Votes and Court Rulings***

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<sup>9</sup> Bundesverfassungsgericht, Maastricht-Urteil vom 12. Oktober 1993, Aktenzeichen 2 BvR 2134/92.

<sup>10</sup> The Bank reopened an unlimited sixmonth credit facility, and said it would continue to offer "full allotment" of liquidity at shorter durations throughout 2011, with support likely to be extended in 2012 and beyond.

At the same time as handling public opinion and constitutional constraints, the government has to convince financial market participants that the stronger euro area members (mainly northern stability oriented countries led by Germany) are prepared give full backing to the single currency. A crucial moment was the Parliamentary vote on the EFSF and in particular the decision on its future involvement when the EFSF acts. The next crucial vote is on the second Greek rescue package and the new ESM. Meanwhile, the overarching debate whether the rescue mechanisms are at all sufficient continue. Even if the extended EFSF is probably insufficient to handle a deteriorating crisis, it was important first step to secure the ratification of its amendments and of the ESM treaty. If there are ratification difficulties in major countries, this in itself is likely to lead to a deterioration of the crisis.

### **The implications of the German Constitutional Court Ruling of September 7, 2011**

A crucial milestone for the reform and implementation of the EFSF and the ESM was the Constitutional Court ruling of September 7, 2011 on the legality of the first Greek rescue package and the EFSF. The Court found that the Parliamentary decisions on the rescue measures are compatible with German Basic Law, but that every rescue measure with a large impact on the budget has to be approved by the Parliament. It is not possible for Germany to participate in an automatic and unmanageable guarantee mechanism which might include euro bonds.

### ***Germany and Economic Governance Reforms***

The sovereign debt crisis shattered German mantras like an earthquake: The European Central Bank is buying sovereign debt on a large scale which has made German commentators tag it as Europe's largest Bad Bank which has lost its independence. The Stability and Growth Pact has lost even further credibility in particular since Greece and some other EMU member states have become candidates for a possible sovereign default.

The No-Bail-Out-Clause has de facto been given up. The perception is wide spread that the eurozone has turned into a currency union *à la française* in which the ordo-liberal framework of the Maastricht Treaty is undermined, and that a transfer union has *de facto* been installed in which those member states that have conducted sound budgetary policies end up paying for those who cheat and behave irresponsibly.

In parallel to the negotiation of rescue packages for euro area members in spring 2010, a profound debate on the reform of the budgetary and economic governance mechanisms has developed. Germany pursued its traditional policy on Euro area governance questions, namely a rule-based approach based on nominal targets and sanctioning mechanisms, a low degree of risk sharing and very little room for political discretion, which is not shared by all of Germany's EMU partners.

Ever since the Maastricht negotiations, Germany sought that the integration of monetary policy—in the absence of a political union which the French government at the time objected to—would be backed by budgetary policy coordination in order to prevent that unsound fiscal policies would undermine monetary stability. This resulted in the introduction of the so-called Excessive Deficit Procedure into the Maastricht Treaty which was supposed to insure budgetary policy surveillance and coordination. In 1996, the German government tabled an additional proposal which it called the Stability Pact to enhance budgetary policy co-ordination that was deemed insufficient after two years of applying it

and even before the Euro was launched. Similar concerns are reflected in the position presented to the Van Rompuy Task Force, which has been set up to sketch-out a reform of the Euro area. One example is the German proposal to withdraw voting rights from member states which break the rules of the Stability and Growth Pact. Another example is German political leaders' opposition to the creation of a regular eurozone summit as had been repeatedly suggested by the French government, fearing that such an institution and closer coordination among the euro area governments could lead to more discretionary policies which could contradict Germany's stability concerns and the ECB's independence. Despite the pressing problems that are unique to the Euro area, the German government's position was initially that fiscal and economic governance should be improved in the EU-27.

This only changed under the severe pressure of the sovereign debt crisis which made Germany accept the idea of a euro area summit, the policy agenda of which it swiftly tried to fill with a detailed proposal for a "Pact for Competitiveness," which later turned into the "Pact for the Euro plus." The new understanding in Berlin is now that top level involvement in the coordination of budgetary and economic policy is necessary in order to strengthen the rules-based approach.

Furthermore, it has become a widely shared assumption in the German debate on euro area governance reform, that private sector involvement in the case of highly indebted member states should be institutionalised with the sovereign debt crisis management mechanism and should occur at an early stage of crisis management.

### ***Recent German/Franco-German Governance Reform Proposals***

In parallel to the negotiation of rescue packages for euro area, a profound debate on the reform of the budgetary and economic governance mechanisms has developed. Consecutive German governments have pursued a particular approach to the governance of the euro area, namely a rules-based approach based on nominal targets and sanctioning mechanisms, a low degree of risk sharing and very little political discretion, which is not shared by all of Germany's EMU partners.

Since spring 2010, a broad reform process of the economic governance mechanisms in the euro area has been launched in parallel to the ongoing crisis management. The current situation is as follows:

- The six legislative acts of the Rehn package have been agreed in September 2011. The legislative acts change the Stability and Growth Pact, improve economic governance coordination and set a common framework for the member states' fiscal constitutions. Some elements will have to be defined upon implementation, for instance elements of the economic score board.
- The European semester has already been implemented for the first time in 2011. Until the next round to be launched in the first half of 2012, first conclusions will have to be drawn.
- The Pact for the Euro Plus has been agreed on 11 March 2011. 24 member states have signed the Pact.<sup>11</sup>
- The Special Euro area summit on July 21st, 2011 has scheduled further ideas for reforms to be tabled, notably to improve working methods and crisis management in the Euro

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<sup>11</sup> The countries that are not yet part of it are the UK, Denmark, the Czech Republic and Hungary.

area until October 2011 and to reduce the role of credit rating agencies in the EU regulatory framework and found a European agency.

The Franco-German initiative of August 2011 sets out several proposals that are likely to determine the future line of reforms. In an open letter to the President of the European Council<sup>12</sup> it makes several proposals.

**Economic governance reform proposals:**

- A bi-annual meeting of Euro Area Heads of State and Government. The purpose is to check the implementation of the SGP, the evolution of competitiveness, discuss problems facing individual member states and imbalances.
- The euro area summit should have a chairman for a 2 ½ year term. Mr. Van Rompuy has been asked to take on the job.
- The ESM should be equipped with its own analytical capacities as regards debt and capital market analysis.

**Proposals to enhanced surveillance and coordination of fiscal and economic policies:**

- All member states should integrate a Balanced Budget Rule by summer 2012 either as part of their constitution or by legislation of an equivalent level.
- All members states should swiftly implement necessary structural changes and adopt recommendations made in the framework of the European semester.
- Call for tax policy coordination in particular “*finalize negotiations on the commission’s proposal on a “common consolidated corporate tax base”*” by the end of 2012.
- The macroeconomic conditionality of the cohesion fund should be extended to the structural fund. The target should be to improve competitiveness and in the case of countries in an excessive imbalance procedure, to reduce imbalances. The Commission should be in charge of the surveillance of the proper use of funds and be involved in the decision making of which projects to fund.
- Funds not used by program countries could be combined in a fund for growth and competitiveness administered by the European Commission.
- Payments from structural and cohesion funds should be suspended if the receiving country is in an EDP.

Merkel and Sarkozy also presented **initiatives concerning only France and Germany:**

- Finance ministers of both countries are to work on a proposal on Financial Transaction Taxes by end of September 2011.
- From January 2012 onwards the two countries will meet at the beginning of each European semester to discuss their economic / fiscal policy and their budget projections.

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<sup>12</sup> [http://www.bundeskanzlerin.de/Content/EN/\\_\\_\\_Anlagen/2011-08-17-dt-franz-brief-eng,property=publicationFile.pdf](http://www.bundeskanzlerin.de/Content/EN/___Anlagen/2011-08-17-dt-franz-brief-eng,property=publicationFile.pdf).

- Finance and Economic ministers are further asked “to prepare a proposal to create a common corporate tax between our two countries, including a harmonized tax base and rates, which would be implemented as of 2013.”

### **Consequences of likely reforms for euro area and EU economic governance**

- ➔ It becomes more and more manifest that the euro area will be equipped with “its own” governance mechanisms, strengthening the institutional base of policy coordination among the EMU-17. This is a chance to increase the ability of the EMU-17 to effectively cope with the crisis and to improve policy coordination and it hence should be seized.
- ➔ Some of the policy coordination proposals consist in potentially strong interference with domestic policy making. Constraints imposed on member states are considerably growing.
- ➔ It will be difficult to gain support among all 17 EMU countries. And it will probably be impossible to gain support from all EU-27 members. So the most likely way forward with substantial steps in economic and budgetary policy coordination will be a “euro area-only” approach for which Germany now seems to be prepared.
- ➔ This trend will consist in a further shift of policy debates from EU-27 for a to EMU-17 fora, similar to the way this has happened between the Ecofin and the Eurogroup ever since its introduction. Hence, EU-27 formats dealing with issues that are subject to EMU-17 coordination in the Eurogroup or during EMU summits should include a short debriefing on EMU debates. The concerns the Ecofin (where this is already implemented), the European Council (dealing with crisis management) and in particular the Spring Council devoted to competitiveness/growth strategy etc., the Competitiveness Council, etc.
- ➔ The Franco-German initiative of July 2011 can be seen as a continuity of the former initiative to introduce a “Pact for the Euro” (which was subsequently enlarged to non-euro area member states and downscaled in its policy content).

### ***Dealing with Imbalances in the Euro Area***

Another sensitive topic in the debate on the euro area’s reform was and is how growing economic imbalances as a result of diverging degrees of competitiveness should be tackled. These have been identified as one of the root causes of the current euro area crisis. There is a broad European consensus that in particular countries with large external deficits need to implement far reaching structural reforms in order to improve their competitiveness. However, on March 15<sup>th</sup> 2010, the Eurogroup acknowledged for the first time that also surpluses need to be critically reviewed.<sup>13</sup> This is a very sensitive point for Germany which has repeatedly been criticized for relying too much on exports and too little on domestic demand as engines of growth.<sup>14</sup>

Some critics argue that Germany has pursued a competitive real devaluation as unit labor costs have stagnated and reductions of the financial burden on the corporate sector

<sup>13</sup> Eurogroup meeting of March 15, 2010, [http://consilium.europa.eu/uedocs/cmsUpload/Rev1clean-ToR\\_on\\_near-term\\_policy\\_priorities\\_of\\_Europe\\_2020\\_in\\_the\\_euro\\_area.pdf](http://consilium.europa.eu/uedocs/cmsUpload/Rev1clean-ToR_on_near-term_policy_priorities_of_Europe_2020_in_the_euro_area.pdf)

<sup>14</sup> See for instance Financial Times: Transcript of interview with Christine Lagarde, published on March 15 2010, <http://www.ft.com/cms/s/0/78648e1a-3019-11df-8734-00144feabdc0,s01=1.html>

have improved its competitiveness. Meanwhile, the increase of the VAT to 19 percent weighs on domestic consumption. German reactions to such criticism are strong as many interpret the debate about imbalances in such a way that Germany's partners request the country "to do worse". Comparisons with the German football team, which cannot possibly be asked to score low for the sake of its neighbors, have been drawn in the public debate<sup>15</sup> and economic performance in the eurozone is pictured as a competitive race. In general, the debate on German export competitiveness often is much more focused on global markets than on the euro area or the EU-27 which may explain why economic policy makers in Germany tend not to understand their European partners concerns over Germany's real devaluations.

Nevertheless, the question whether Germany needs to do more for domestic demand is nowadays regularly raised in political debates in Berlin and will be more so if export driven growth decelerates in the years to come. There is a rising concern (for instance among some Social Democrat and Green politicians in the German Parliament as a number of public hearings in Parliamentary Committees show) that Germany will have to do more for domestic demand in its own interest.<sup>16</sup> There are two major arguments why: Firstly, because Germany has clear self-interest that the euro area finds back to a situation of robust growth and sustainable public finances for which a strongly growing German economy is a prerequisite. Secondly, because if the euro area partners substantively increase their competitiveness, German as a consequence may lose market shares in certain segments and will hence have to rely more strongly on domestic growth.

**The following section gives a brief overview over the key positions of the political parties present in the Bundestag and selected actors from business and banking.**

**CDU:** The conservative CDU (Christian-democrats) are pro European but divided about how to best tackle the debt crisis. The latest dispute has been about the future role of national parliaments in the governance structure of the EFSF and later ESM. Parliamentary members have harshly criticized Chancellor Merkel and Minister of Finance Schäuble for apparently trying to keep the national parliament out of future decisions about financial assistance granted (a criticism which all parties share). In influential member of Parliament, Wolfgang Bosbach, has openly stated his intention to vote against the EFSF in late September. Whether Merkel will be able to get a majority of her own coalition is not certain. Another contentious issue is the introduction of Eurobonds. While Merkel and Schäuble have stated that Eurobonds need to go hand in hand with a deeper integration of fiscal policy across the eurozone, many members of the CDU want a general rejection of the idea.

**CSU:** The smaller, but influential sister of the CDU, the more conservative CSU (only present in Bavaria) has a harder stance toward Eurobonds. They reject them altogether arguing that interest rates differentials are the only advice that will discipline national budgets. Nonetheless they support Merkel in her attempts to stabilize the eurozone. They support the intention to introduce debt-brakes in all eurozone member states, a financial transaction fee as announced together with French President Nicolas Sarkozy and in the pursuit of improved fiscal policy coordination.

<sup>15</sup> See for instance Herman-Otto Solms' statement in the Economic Committee Hearing of June 16, 2010.

<sup>16</sup> See for instance: Heiner Flassbeck, Gustav Horn, Sebastian Dullien: Europa hat noch eine Chance, in: Financial Times Deutschland, 05.05.2010, p. 24.

**FDP:** The FDP (liberals) firmly reject any instrument that resembles the idea of debt reduction or debt collateralization even though they eventually gave in to the mounting pressure of installing the EFSF. As the parliamentary Members of the CDU/CSU, they demand an ongoing involvement of the parliament in EFSF and future ESM decisions. FDP's Frank Schäffler has been the first (and remains one of the few) to openly demand a split of the eurozone. They criticize the ECB for buying government bonds on the secondary market which is a form of collateralizing the debt as well as turning the ECB into a bad bank. Very recently, party chairman Philip Rösler has not excluded Greece going bankrupt and leaving the euro area as a policy option.

**SPD:** The Social Democrats point out that the cause of the debt crisis was a financial crisis which via the bail out of banks turned into a debt crisis, which is why they make a strong case for financial regulation. They blame Chancellor Merkel for being responsible of the spread of the crisis, saying she postponed profound decisions due to state elections. In their view the austerity program for Greece is counterproductive because it kills of economic growth and thus makes an end of the crisis in Greece unlikely. Current account imbalances are seen as one of the core flaws of the Monetary Union and are due to excessively low real wage settlements (a point which all opposition parties share). Adjustment should be asymmetric to reduce the burden on the deficit countries. Eurobonds are seen as a way of ending the crisis.

**Die Grünen:** The Greens also criticize the government for postponing bold decisions due to state elections and for not addressing the issue of asymmetric adjustment of current account imbalances. The Greens have argued for the introduction of Eurobonds, a sovereign default procedure and economic stimulus programs based on the Green New Deal. The Greens tend to frame the euro area as part of a wider "future of the EU"-debate including proposals how to make the EU more democratic and legitimate.

**Die Linke:** The Linke (the left) calls for a quantum leap forward in surveillance of the financial sector as well as the nationalization of banks. For Die Linke a German reorientation away from exports to a more internal driven expansion is tantamount. They argue that the previous aid packages have only helped to bail out private investors at the expense of taxpayers and demand a euro-wide investment program, support the introduction of Eurobonds and an international financial transaction tax as well as an exceptional contribution of European millionaires to help pay for the crisis.

**President Christian Wulff:** In a recent statement, the German President has criticized the ECB for intervening in the secondary market. He said he judges the interventions to be politically and legally questionable.

**BDI (German business federation):** The German business federation has called for a treaty change and the creation of the European Fiscal Fund instead of the EFSF and the ESM. The EFF should provide countries with rescue packages which run no longer than three years and impose strict economic and fiscal conditionality. The EFF and the ECB would be distinct and independently operating pillars of the EMU's financial architecture.

#### 4. Germany in the EU with Lisbon

##### *Leadership Dynamics: Combined Effects of Lisbon and the Crisis Mode*

The simultaneous implementation of the Lisbon Treaty, the management of the crisis and the economic governance reforms have considerably changed the political functioning of the European Union. Power relationships have shifted towards the European Council and, in particular, to the larger member states. At the core of the system is Germany, which is the main guarantor of the EFSF and the future ESM with a share of 28 percent, which has been the strongest performing economy of the euro area in the last two years and the Chancellor of which probably has the most direct and influential access to Council President Herman Van Rompuy.

The Treaty of Lisbon has brought about changes to the general institutional setting and decision-making procedures, some of which have taken an unexpected turn. The Treaty was up-front perceived as bringing more supranationalism to the European Union. But in the course of 2010 an intense debate evolved whether the EU had rather become more intergovernmental and who was actually holding the power. The new role of Germany, which some have tagged as a new hegemon, has raised particular interest.

The most relevant change for the question of leadership and power relationships was the installment of the permanent President of the European Council. He has not profiled himself as a strong leader with a policy agenda. But already his first year in office has shown that his responsibility to propose the agenda, prepare and chair the meetings and present the conclusions give him considerable power as agenda setter as long as he manages to secure the backing of the national leaders. Before taking action at European Council meetings, he has to get a sense of member governments' preferences and has so far apparently closely consulted the Heads of State and Government of the large member states.

The Lisbon Treaty also put a term to the rotating council Presidency in its previous shape, reducing its agenda setting ability. The rotating presidency's role is still key—but more as a “service provider”<sup>17</sup> than as a profiled policy entrepreneur. This tendency has particularly been strengthened by the crisis management mode in which the EU has been operating since 2008/2009 and this for three reasons: firstly, the European Council has become particularly active in defining the reactions to the sovereign debt crisis, secondly, if the Finance Ministers are involved, the most relevant forum is the Eurogroup which the rotating Presidency does not chair, and thirdly, the short-term orientation towards crisis management leaves little room for political impulse and agenda setting attempts by the rotating Presidency.

Also the European Commission had to struggle for its standing. The seizure of longer-term policy orientations and strategic reflection by the European Council has challenged its role both in crisis management and in the process of economic governance reform. This trend may continue—in particular if the European Council is less occupied with the financial, debt and banking crises and turns to other policy areas.

The European Parliament, in contrast, is one of the institutions that benefits most of the Lisbon Treaty. With the new Treaty, the co-decision procedure has now become the

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<sup>17</sup> Nicolai von Ondarza: Politische Koordinatoren an der Spitze. Politische Führung in den reformierten Strukturen der Europäischen Union, SWP-Studie, April 2011, [http://www.swp-berlin.org/fileadmin/contents/products/studien/2011\\_S08\\_orz\\_ks.pdf](http://www.swp-berlin.org/fileadmin/contents/products/studien/2011_S08_orz_ks.pdf).

“ordinary legislative procedure” which puts the Parliament on an equal footing in all related legislative procedures. Its powers have thus for instance increased in the fields of Justice and Home Affairs as well as cohesion and agricultural policy and the negotiation of trade agreements. The Lisbon Treaty also gave the Parliament more rights in budgetary policy, as it expands the scope of Parliamentary control, gives the EP a stronger role in the determination of annual budgets and it has to give its consent for the EU’s seven year financial framework.

Throughout the first year of Lisbon, the Parliament pursued its strive for an equal footing with the Council in the EU’s institutional triangle. In September 2009, in an unprecedented move, it committed Manuel Barroso, who was candidate for a second term as President of the European Commission, to detail his key political projects for his second term as Commission President before the European Parliament. This gave the Parliament’s power to appoint and dismiss the European Commission a new quality and can be seen as an attempt to have a say in the setting of long-term policy priorities—which it formally does not have, despite its strengthened role thanks to Lisbon.<sup>18</sup>

But despite the upgrade of the European Parliament and despite the strengthening of leadership on the European level, many observers conclude that the EU has recently become more intergovernmental, some even observed a renationalization.<sup>19</sup> This impression is mostly a result of the strengthening of the European Council under its President, in particular in the management of the crisis and the governance reform process, for instance by the Van-Rompuy-Task-Force.

The trend towards intergovernmental cooperation bears a conflict potential – not only with the EU’s supranational institutions. In particular, small and medium-sized member states are skeptical and criticize the dominant role of the large member states more and more openly. In 2010, the Franco-German Deauville compromise on the reform of the Euro area caused criticism in other European capitals, and in particular in those which hold or were going to hold the rotating Presidency. Unlike in previous events of Franco-German leadership, both governments did not consult their partners before tabling their proposal at the subsequent European summit. A similarly explosive case was the last minute package deal between London, Paris and Berlin in which the British Prime Minister secured a guarantee of the British rebate in exchange for Germany’s insistence to revise the EU Treaty when installing the sovereign debt crisis mechanism. It is an open secret that the Council President closely consults with the German Chancellor and the French President but is said to pay less attention to the Heads of State and Government of small and medium-sized member states. This is no new phenomenon and parallels the behavior of most Commission Presidents.

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<sup>18</sup> This practice and other elements that strengthen the EP as an actor in the institutional triangle of the European Union are laid down in the revised “Framework Agreement on relations between the European Parliament and the Commission” of October 2010. This agreement of course does not alter the EP’s role as enshrined in primary law, but it is widely seen as being an important tool for the Parliament to further extend its influence over the running legislature.

<sup>19</sup> However, even if the EU has become relatively more intergovernmental, there are to date apart from the Opt-Out-cases of the Schengen Agreement, no cases in which an actual renationalisation has taken place and in which the community method has actually been pushed back. At least in 2010, intergovernmental approaches were chosen in those fields where the community method does not apply—and hence can be read as a way for the European Union to expand its scope of action.

### *A Non-Solicited Leadership Role*

Rather involuntarily, Germany has slipped into a new leadership role in the EMU: it has strongly shaped the eurozone reform debate and it sets the pace for other member states through its ambitious consolidation agenda. Germany's partners, including France, seem to feel considerable pressure to follow Berlin's policy choices as markets sanction domestic developments much more sensitively since the sovereign debt crisis. The intensified debate whether EU countries should introduce domestic fiscal rules somewhat similar to Germany's "debt brake" is no coincidence.

There are striking parallels to the pre-EMU-situation when Germany's partners shadowed the Bundesbank's monetary policy in order to maintain exchange rate stability to the Deutschmark: currently, Germany's budgetary and economic policy decisions raise the stakes for other governments who may diverge in their assessments of suitable policies, as financial markets measure all other governments against the German one, as interest spreads between the German government bonds and those of its European partners show. If this trend persists, the question is how politically sustainable the situation will be in the long run. In the near future, Germany may increasingly be confronted with a new debate on its responsibility for the economic development of the eurozone. This will not be an easy discussion, in particular as its successful growth model is the result of an adaptation process based on tough structural reforms, wage restraint and fiscal austerity which were justified (and broadly accepted) as a necessary consequence of its own reunification and the fact that Germany entered the EMU at an overvalued exchange rate.

The fact that the eurozone's internal divergences may not be solved solely "if the others do their homework, too" will require sensitive and far-sighted debates between Germany and its EMU partners.<sup>20</sup> A particularly strong role is again to be taken by Germany, and France, which add up to 48 percent of eurozone GDP.

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<sup>20</sup> In Germany, comparatively little attention is paid to the intense debate on the German growth model that has developed in France both in the media and in the academic sphere, see for instance: Rémi Lallement: *Le régime allemand de croissance tirée par l'exportation : entre succès et remise en cause*, Document de Travail, Centre d'Analyse Stratégique, mai 2010. <http://www.strategie.gouv.fr>; Patrick Artus : Patrick Artus, « La politique économique de l'Allemagne est-elle un problème pour les autres pays européens? », *Natixis Flash*, 8 décembre 2009, n° 538.