

GERMANY AND THE STABILITY OF EUROPE'S ECONOMIC AND MONETARY UNION

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EXECUTIVE SUMMARY

Germany has played an important part in designing the architecture of the euro and has been a decisive actor in recent efforts to repair the eurozone. **How has Germany's concept of a "stability community" shaped EU policy** and to what extent has it been successful in stabilizing the common currency?

In the euro's founding phase, German demands concentrated on low inflation rates and low levels of government debt. Yet it became apparent in the crisis that **Germany's idea of stability was narrowly defined**. Apart from a lack of budgetary discipline, key destabilizing factors included current account imbalances, a lack of crisis management tools, and the self-reinforcing dynamics between weakened banks and over-indebted states - all of which had all been largely ignored prior to the crisis.

Over the course of the crisis, **the German government has broadly adhered to its traditional concept of stability** based on control and supervision of eurozone members. At the same time **Germany has repeatedly acted in a pragmatic manner to safeguard the existence of the eurozone**. It was willing to lend support to the creation of the European Stability Mechanism and the Banking Union and countenanced the ECB's extraordinary measures.

Despite the reform efforts of the past years, **the eurozone still has some serious design faults** that threaten the very stability of the common currency. Yet member states disagree on the necessary parameters for a stable currency union and differences in perceptions and preferences have met head-on in the course of the recent reform debates. German policy on Europe should try to play a constructive role by spelling out **under which circumstances increased risk sharing in the euro area would be acceptable**.

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INTRODUCTION

The European Economic and Monetary Union is immersed in a crisis of historic proportions. In 2008, on the tenth anniversary of the introduction of the euro, the common currency was still being singled out as an anchor of stability and an example of successful supranational cooperation.¹ Yet since the start of the crisis in 2010 it has become apparent that the euro area in its present form has some serious design faults. At the time of the dramatic negotiations on the third bailout package for Greece in the summer of 2015 the disintegration of the monetary union began to look like a distinct possibility. The vast majority of commentators are of the opinion that the monetary union cannot be crisis-resistant and stable in the long run unless a number of crucial points are amended.

There have been numerous proposals for reform, most recently the report by the five European presidents on the completion of the economic and monetary union.² However, different perceptions of the problems and different political preferences have met head-on in the course of the debate. Among other things, there is currently disagreement about sharing more sovereignty and risk.³ To put it in a nutshell, the European Union and its member states are still looking for an effective and coherent way of stabilizing the common currency.

In point of fact the eurozone countries were already grappling with the issue of how to define the parameters of a stable currency union before the start of the crisis. During the negotiations on the common currency in the late 1980s and the 1990s there was a great deal of disagreement about the design and structure of the euro. Above all it became apparent that Germany and France had different interests, and that their ideas about the way in which a common currency might work in practice did not coincide. The Germans thought that the stability of the Economic and Monetary Union should be based on low inflation rates and low levels of government debt, and that these should be guaranteed by a convergence process among the eurozone candidates before the start of the monetary union.

” THE CURRENCY UNION HAS NOT BEEN THE KIND OF “STABILITY COMMUNITY” THAT GERMANY HAD ENVISAGED ”

How has Germany's concept of a “stability community” shaped EU policy and to what extent has it been successful in stabilizing the common currency? On paper at least Germany managed to gain acceptance for its ideas on many aspects of the design and structure of the euro. However, in practice the currency union has not been the kind of “stability community” that Germany had envisaged. To all intents and purposes the goal of low inflation has been reached in the 15 years or so since the introduction of the euro. However, when one looks at the levels of debt of the national budgets, the results over this period have been rather patchy. And there has even been a trend reversal in the convergence process. Until 1998 the economies in the euro area converged at a rapid pace, but after the introduction of the euro they slowly began to drift apart.⁴

It became apparent that Germany's idea of stability within the monetary union was narrowly defined. It is of course true that a lack of budgetary discipline was one of the catalysts of the euro crisis that erupted in 2010, but it was not the only reason for what happened, nor the most important one. Thus a key role was played by

1. See European Commission, *EMU@10: Successes and Challenges after 10 years of Economic and Monetary Union* (Brussels, 2008).

2. Jean-Claude Juncker et al., *Completing Europe's Economic and Monetary Union* (Brussels: European Commission, June 2015).

3. See also Katharina Gnath and Jörg Haas, “A Fiscal Union for Europe - Building Block and Not a Magic Bullet,” *spotlight europe 4* (Güterloh: Bertelsmann Stiftung, October 2015).

4. Anna auf dem Brinke, Henrik Enderlein and Joachim Fritz-Vannahme, *What kind of convergence does the euro area need?* (Güterloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin, 2015).

factors which prior to this had gone largely unnoticed. They included imbalances in the current accounts of the eurozone countries and the interdependence of the state and financial sectors (“sovereign-bank nexus”).

The crisis highlighted Germany’s important role in the architecture of the euro. The German government pursued policies driven by profound anxieties about the risk of “moral hazard” in other eurozone members, and adhered to its traditional notion of stability brought about by control and supervision of the euro area member states. At the same time Germany repeatedly acted in a pragmatic manner during the crisis in order to safeguard the existence of the eurozone. Amongst other things it countenanced the de facto abolition of the “no-bail-out clause” that was implied by the creation of the European Stability Mechanism and the establishment of the Banking Union. Furthermore, the German government did not object to crucial measures adopted by the European Central Bank (ECB), which included government bond purchases starting in 2010 and the decision to proceed with Outright Monetary Transactions (OMT) two years later.

” THE EURO CRISIS
CLEARLY DEMONSTRATED
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ORIGINAL MAASTRICHT MODEL”

The euro crisis clearly demonstrated the shortcomings of the original Maastricht model. Thus, in spite of the reforms introduced in recent years, there is an inescapable need for further improvements. But Europe now seems to have reached a point at which Germany is unwilling to support greater risk sharing in the monetary union unless more sovereignty is transferred to the European level. As far as France and many other countries are concerned, this is unacceptable. Does that mean we have reached a eurozone stalemate? Or is another pragmatic compromise still on the cards?

German policy on Europe now needs to play a constructive role in the reform efforts. For this reason it has to answer the question of how much sovereignty-sharing and economic convergence is required in order to agree to greater risk sharing within the monetary union.

The remainder of the policy paper is organized as follows. Section I focuses on Germany’s stability-oriented interests and strategies in the founding stages of the common currency. Section II elucidates the reasons for the instability which, after 2010, plunged the euro into an existential crisis. Section III analyses the extent to which the new governance structures that were established in the course of the recent reforms are compatible with German notions of stability. Sections IV and V are devoted to the faults in the design and structure of the euro that still exist, and describe the elements that are needed in order to improve the stability of the eurozone. The conclusion examines the role of Germany in the forthcoming reform process.

1. Competing demands for stability

” IN THE NEGOTIATIONS ON
THE TREATY OF MAASTRICHT
THERE WERE TWO DIFFERENT
APPROACHES: A GERMAN AND
A FRENCH”

The European internal market has always been a core element of European integration. The purpose of the 1992 Single Market programme was to dismantle the remaining barriers. It was supposed to open the European economies and to intensify intra-European trade. Fluctuating exchange rates are not compatible with a complete internal market for the simple reason that it is possible to secure short-term competitive advantages with the help of currency devaluation. Thus the project of a common European currency, which was revived in the late 1980s and adopted in the Treaty of Maastricht in December 1991, was among other things a functional response to

the internal market.⁵ However, there was as yet no answer to the question of how the common currency was

5. European Commission, “One market, one money. An evaluation of the potential benefits and costs of forming an economic and monetary union,” *European Economy* 44 (Brussels: October 1990); Tommaso Padoa-Schioppa et al., eds., “Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the EC,” Report of a study group appointed by the Commission of the European Communities (Brussels: April 1987); see also Henrik Enderlein, “Towards an Ever Closer Economic and Monetary Union? The Politics and Economics of Exploratory Governance,” in *Beyond the Crisis: The Governance of Europe’s Economic, Political and Legal Transformation*, Mark Dawson, Henrik Enderlein and Christian Joerges, eds. (Oxford: Oxford University Press, 2015), 13-23.

going to be implemented. In the negotiations on the Treaty of Maastricht there were in the main two different approaches. They were advocated by Germany on the one hand and France on the other.

Convergence. A point at issue was the question of how much economic convergence a monetary union actually needs. The French approach was based on the idea that the process would begin with the common currency, which would be backed up by an economic government. This in turn would make it possible to create a homogenous single monetary area over time. In contrast to this, the German approach emphasized the necessity of a priori economic convergence. An integrated economic area had to emerge before the advent of the common currency, which was going to be a kind of cornerstone or “coronation.” In the gradual approach favoured by Germany the first round of the monetary union, if need be, would begin with no more than a handful of states that were ready to introduce the euro.⁶ Thus the German negotiators advocated stringent and quantitatively defined convergence criteria that member states would be required to meet before gaining admission to the monetary union. They concentrated on low levels of budgetary indebtedness and the convergence of inflation rates. What eventually emerged was a compromise. Although the common currency was introduced almost everywhere, there was no institutional framework capable of promoting the emergence of a homogeneous economic area once the countries had been admitted.

” FOR MANY POLITICIANS
IN GERMANY THE FRENCH
PROPOSALS FOR AN
ECONOMIC GOVERNMENT
WERE A TABOO SUBJECT”

Monetary policy. In the founding phase another issue was the degree of independence to be accorded to the new European Central Bank, which was going to be responsible for the common monetary policy. France agreed to the overall principles of price stability and the independence of the ECB.⁷ However, early on in the negotiations the French delegation made it clear that such independence could exist only within a robust political framework on the EU level and demanded that exchange rate policy would be the responsibility of policymakers (ECOFIN).⁸ The “gouvernement économique,” a kind of European economic government which could act as a political counterbalance to the independent central bank, became one of the central elements in the French vision of the management of the common currency. For many politicians in Germany the French proposals for an economic government were a taboo subject from the very start, partly because it was never possible to describe its tasks with any kind of precision. In addition to a robust anti-inflationary mandate, the depoliticization of monetary policy with the help of an independent central bank was one of the principal German demands when it came to the design and structure of the euro. The Bundesbank saw the French proposals as a “Trojan horse” that threatened to undermine the ECB’s independence and the goal of price stability enshrined in the Treaty of Maastricht.⁹

Economic policy. The 1989 Delors Report came to the conclusion that economic and fiscal policy decisions had to be made within an agreed macro-economic framework, and based on legally binding processes and regulations.¹⁰ Here again there were significant differences between Germany and France. The German proposals for the Treaty of Maastricht did not contain any references to a financial mechanism or a common economic policy. Germany obtained support for its view that the ECOFIN Council should merely issue “guidelines” in the field of economic policy (i.e. Broad Economic Policy Guidelines) and not legally binding directives. Thus the Treaty of Maastricht did not imply the existence of a common policy or a common political authority in this area. It merely obliged the member states to coordinate their economic policies loosely and to avoid excessive budget deficits.

6. Wayne Sandholtz, “Choosing union: monetary politics and Maastricht,” *International Organization* 47:1 (Winter 1993), 1-39 (p. 16); Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999), 431.

7. See Alexander Italiener, “Mastering Maastricht: EMU issues and How They Were Settled,” in *Economic and Monetary Union: Implications for National Policy-makers*, Klaus Gretschmann, ed. (Dordrecht and Boston: Martinus Nijhoff, 1993), 51-113.

8. E.g. French Council of Ministers, *Communiqué du Conseil des ministres français vers l’Union économique et monétaire* (Paris: December 1990), §2a; see also Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999), 222; David Howarth, “Making and breaking the rules: French policy on EU ‘gouvernement économique,’” *Journal of European Public Policy* 14:7 (2007), 1061-78.

9. Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999), 428; Kenneth Dyson, *Elusive Union: The Process of Economic and Monetary Union in Europe* (London and New York: Longman, 1994), 147; Jean Pisani-Ferry, “Only One Bed for Two Dreams: A Critical Retrospective on the Debate over the Economic Governance of the Euro Area,” *Journal of Common Market Studies* 44:4 (2006), 823-944.

10. Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community* [Delors Report] (Luxembourg: Office for Official Publications of the European Communities, April 1989); see also Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999), 411; for a recent assessment of the Delors Report see Henrik Enderlein and Eulalia Rubio, “25 Years After the Delors Report,” *Policy Paper* 109 (Paris: Notre Europe – Jacques Delors Institute, 30 April 2014).

Budget discipline. In the founding stages the future member states were unanimously in favour of budget discipline.¹¹ The debate centred above all on the stringency of the implementation mechanisms in general and on the imposition of sanctions in particular.¹² As far as Germany was concerned, a stability-oriented budget policy signified strict rules against excessive budget deficits and the imposition of sanctions as defined in the treaty whenever they were broken. In the preparatory phase (“second stage”) that preceded the monetary union Theo Waigel, the then German Minister of Finance, suggested that there should be a stability pact that would ensure budget discipline among the member states after the introduction of the euro. The Stability and Growth Pact was adopted in 1997 in order to attain balanced national budgets in the long term. Furthermore, in the negotiations Germany successfully resisted the idea of bailouts, and advocated the ban on monetizing government deficits in order to ensure a disciplining effect of market mechanisms on budgets.

On the surface the architecture of the euro which finally materialized, and to all intents and purposes took its bearings from the German notion of stability, seemed to be a success in the initial phase. As late as 2008 a Commission report on the tenth anniversary of the introduction of the euro came to a very positive conclusion and stated that the common currency was a pillar of macro-economic stability.¹³ A short time later the very existence of the monetary union was being called into question. How could this have happened?

2. The roots of instability

” THE VULNERABILITY OF THE COMMON CURRENCY CAN BE TRACED BACK TO ITS ORIGINS AS A MONETARY UNION IN A HETEROGENEOUS ECONOMIC AREA”

To a large extent the vulnerability of the common currency can be traced back to its origins as a monetary union in a heterogeneous economic area. There was an unspoken assumption that a convergence process would automatically materialize if a few basic rules were observed. The European economies, it was thought, would converge in the course of time as a result of increasing economic exchange.¹⁴ This idea turned out to be too optimistic. Thus the economic cycles of the eurozone countries failed to converge. For this reason the ECB’s single monetary policy, which was based on average inflation rates, could not have a stabilizing effect. Its interest rate levels were too low for countries with rapid growth and high inflation rates, and too high for countries with sluggish growth and low inflation rates (“one size fits none”).¹⁵ In this way it fuelled a process of divergence that ultimately materialized in very different levels of competitiveness.

Imbalances. This turned out to be a problem in the euro area because its adjustment mechanisms were weak. A system of national currencies would have been able to deal with the issue in the medium term with the help of changes in the exchange rates. In the absence of an exchange rate channel there ought to have been other adjustments. For example, greater convergence of the economic areas could have been achieved via wage levels. In fact, wage adjustments that take their cue from national productivity would have been unavoidable in a completely integrated internal market. However, the economic areas of the common currency were rather self-contained, so wage levels were able to diverge. A more politically coordinated monetary union could have intervened by insisting on the incorporation of direct and legally binding provisions in the tax, the budgetary and perhaps even the wage policies of the nation states. However, the euro area had none of these tools. Furthermore, Europe did not possess other adjustment mechanisms such as a common budget, common unemployment insurance, or high labour mobility, which exist in other heterogeneous currency areas. Consequently the adjustments were left to the individual member states. However, they failed to materialize.

11. E.g. Wayne Sandholtz, “Choosing union: monetary politics and Maastricht,” *International Organization* 47:1 (Winter 1993), 1-39 (p. 5).

12. Andrew Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Ithaca: Cornell University Press), 445.

13. European Commission, *EMU@10: Successes and Challenges after 10 years of Economic and Monetary Union* (Brussels, 2008), 3.

14. Jeffrey Frankel and Andrew Rose, “The Endogeneity of the Optimum Currency Area Criteria,” *NBER Working Paper* 5700 (August 1996), 1-33.

15. Henrik Enderlein, “One Size Fits None,” *Central Banking* XVI:1 (2005), 24-28; Henrik Enderlein, *Nationale Wirtschaftspolitik in der europäischen Währungsunion* (Frankfurt: Campus, 2004).

Contrary to European Treaty provisions, many of the eurozone countries did not “regard their economic policies as a matter of common concern” (Art. 121 TFEU).

This divergence was reflected in the current accounts of the euro area. Whereas Germany and the Netherlands ran high surpluses, states such as Ireland and Spain had high deficits. As a result, their private debt levels increased. In Greece this trend was accompanied by excessive public spending, the full extent of which became apparent later on when it turned out that the Greek deficit figures were inaccurate. The financial crisis and the contagion which followed in the wake of events in Greece in the autumn of 2009 and early in 2010 almost brought the increasingly unstable currency to its knees. However, the crisis unfolded across Europe in unexpected ways. Only some of the countries that were worst hit, e.g. Portugal and Greece, were already considered to be problematical cases before the advent of the crisis. But countries such as Ireland and Spain were also badly hit even though they had adhered to the debt and deficit rules. A third group, which included Germany and France, had broken the rules, but remained stable.

Rule failure. German hopes that it would be possible to uphold the stability of the monetary union with the help of a system of rules and by emphasizing budgetary self-responsibility were dashed for three reasons. First, the no bailout principle, that is, the ban on community liability for debt (Art. 125 TFEU), was no longer considered to be practicable during the crisis early in 2010. What is more, the almost total convergence of government bond interest rates after the introduction of the euro suggests that the financial markets never in fact believed in the no bailout rule. Second, the majority of the eurozone countries were not prepared to adhere to the rules enshrined in the Stability and Growth Pact when the economy was in trouble, or to build up sufficient reserves when the going was good. The decision of the EU Council of Ministers in 2003 to abandon the excessive deficit procedure against Germany and France illustrates this very precisely. The light-hearted way in which the Irish government greeted the “blue letter” from the Commission in 2001 also underlines the weakness of European coordination. The Commission had neither the requisite political clout nor the legal powers to impose sanctions every time someone broke the rules. However, there was a third reason, and it was even more serious. The fact was that the significance of imbalances in the private sector and their interaction with public finances had been completely underestimated. In the final analysis this turned out to be the most serious problem of the eurozone, but it was not referred to in the original set of rules and regulations which were supposed to stabilize the common currency.¹⁶

Lack of crisis management. The high level of public and private indebtedness increased the likelihood of destabilization. But equally importantly, the negative ramifications were exacerbated by a lack of rapidly deployable and effective crisis management instruments. This was especially noticeable in the case of the “self-fulfilling insolvency” phenomenon. Half-hearted support for countries with temporary liquidity problems reinforced doubts about their creditworthiness, and this, via higher interest rates on government bonds, weakened their actual solvency.¹⁷

The sluggish political response of the euro area was partly due to the fact that the European Union did not have at its disposal any ready-made mechanisms for dealing with crises in the monetary union. Old lines of conflict began to make a reappearance. Should stability be attained by more stringent rules and regulations, and market discipline, or through the communitarization of responsibility and coordinated economic policy? German policymakers found themselves in a cleft stick. On the one hand they wanted to avoid the communitarization of debt, and on the other they realized that Greece’s financial problems could spread to other countries and cast doubt on the currency union as a whole. In the end the eurozone countries had to come up with specific answers in a very short space of time and in an environment of high uncertainty. They settled for intergovernmental action that led to relatively fast results and direct control over the use of European emergency assistance. This made it easier to experiment with new instruments, but it came at the expense of long-term and pan-European ideas.¹⁸

16. Richard Baldwin and Francesco Giavazzi, eds., *The eurozone Crisis. A Consensus View of the Causes and a Few Possible Solutions* (London: Vox.Eu, December 2015); Philip R. Lane, “The Real Effects of European Monetary Union,” *Journal of Economic Perspectives* 20:4 (2006), 47-66 (p. 20).

17. Paul de Grauwe, “A Fragile eurozone in Search of a Better Governance,” *CESifo Working Paper* 3456 (May 2011), 1-30.

18. Mark Dawson, Henrik Enderlein and Christian Joerges, “Introduction: Exploratory Governance in the Euro Crisis,” in *The Governance Report 2015* (Oxford: Oxford University Press, 2015), 13-24.

In the German debate on the subject the crisis of the “eurozone periphery” was for a long time perceived primarily to be a government debt crisis which had come about largely as a result of failing to adhere to the deficit rules.¹⁹ However, the “euro’s three crises,” i.e. government debt, banks and growth, were always closely interlinked.²⁰ The German focus on government debt had a lasting effect on the responses of the eurozone member states. This is demonstrated by the various counter-measures that were put in place. The European Financial Stability Facility (EFSF), which was established as early as the middle of 2010, was designed to prevent defaults with a combination of emergency loans and austerity measures. Later, in expanded form, it became the European Stability Mechanism (ESM). Measures designed to prevent macro-economic imbalances were introduced at the end of 2011. The self-reinforcing dynamics in the euro area between weakened banks and over-indebted states were tackled only between 2012 and 2014 through steps towards a European Banking Union.

”GERMANY’S ORIGINAL IDEA OF STABILITY WAS TOO NARROW FOR THE MONETARY UNION”

It became apparent that Germany’s idea of stability was too narrow for the monetary union. Budget discipline was certainly important, since in the event of a crisis a state with low levels of indebtedness has more room for manoeuvre for anti-cyclical policies. This kind of room for manoeuvre has often been lacking in the current turmoil. However, other factors such as the inability to adjust to different economic cycles, the lack of crisis management instruments, and the danger of a dynamic and self-reinforcing interaction between weakened banks and over-indebted states contributed substantially to the instability in the eurozone.

3. Eurozone reforms to date

How do the new governance structures tally with German notions of stability? The reforms designed to stabilize the design and structure of the euro that have been adopted since 2010 can be divided into two categories, i.e. crisis prevention and crisis management.

Greater control. The measures designed to improve crisis prevention seek to create stability by tightening the existing rules. The emphasis is on greater control of national budget policies. Two sets of EU legislation (the “six-pack” and the “two-pack”) and the intergovernmental Treaty on Stability, Coordination and Governance (“Fiscal Compact”) have made it easier to punish violations of the budget rules and introduced a debt brake on the national level. Furthermore, the scope of the rules has been enlarged. Imbalances in the private sector and wage costs are now subject to European supervision in the shape of the Macro-economic Imbalance Procedure, and for the first time can lead to the imposition of sanctions.

Mutual insurance. The changes in the system of crisis prevention correspond to the German idea that control is an important anchor of stability. On the other hand, the new European crisis management system is based to a certain extent on a new concept of stability, namely one based on mutual (albeit limited) insurance. The temporary EFSF and its permanent successor, ESM, moved very close to the idea of common liability for debt and thus marked a break with the “old” German position. It is true that the legal provisions of both EFSF and ESM avoid a de jure common liability for debt, but the fact that states are kept solvent with the help of a common fund introduced a new dimension into the monetary union. Many people believed that this step was unavoidable. It was the only way in which the monetary union could get to grips with its most obvious and potential weakness, a self-fulfilling government insolvency. However, the way in which ESM functions is still rooted in the old Maastricht model. The member states (and not the European level) control the disbursements and there is an upper liability limit. Furthermore, loans to countries in financial distress are made available only for a limited period and only in return for the implementation of austerity programmes and structural reforms. This is

19. See, for example, the statement by Chancellor Angela Merkel on the European Council and the Euro Summit (Berlin: German Bundestag, 26 October 2011).

20. Jay C. Shambaugh, “The Euro’s Three Crises,” *Brookings Papers on Economic Activity* (Spring 2012).

designed to guarantee what Jens Weidmann, the President of the German Bundesbank, and German Finance Minister Wolfgang Schäuble keep calling for on a regular basis, the “unity of liability and control.”²¹

Banking Union. The Banking Union is another important building block in the euro area’s new crisis management system. The establishment of the Single Supervisory Mechanism, the involvement of creditors in bank restructuring costs, and the creation of a Single Resolution Mechanism will make it possible in future to reduce the impact of a banking crisis on government finances and thus the potential for contagion within the eurozone.²² These measures did not form part of the original German ideas on stability, but are certainly compatible with them.

ECB. Furthermore, the role of the ECB changed as the crisis unfolded. It filled the institutional vacuum left behind by the lack of unanimity among the eurozone countries. There is a certain irony in the fact that this was partly due to the interplay between German opposition to common debt and the institutional independence of the central bank that Germany has espoused with such vigour. The ECB’s original task of acting as a “guardian of price stability” grew and expanded, and it became a “guardian of the currency.” In legal terms this interpretation is understandable. A currency in which the transmission channel of monetary policy no longer functions because far too many market participants believe that a country is about to withdraw cannot create price stability. However, in Germany this interpretation of the ECB’s mandate was construed as a departure from the classical German ideas about the tasks of a central bank. The resignations of Axel Weber as head of the Bundesbank and of Jürgen Stark as chief economist of the ECB at the end of 2011 were a reflection of this.

“GERMANY BECAME WILLING TO ACCEPT REFORMS THAT HAD PREVIOUSLY SEEMED IMPOSSIBLE IN ORDER TO ENSURE THE SYSTEMIC STABILITY OF THE COMMON CURRENCY”

In the course of the reforms to date, Germany has, overall, adhered to its traditional ideas of achieving stability with the help of controls. Uppermost in the minds of German policymakers is the fear of moral hazard among the other members of the eurozone. This was reflected in the insistence on stricter rules for budget deficits and the fact that the ESM adjustment programmes focused on competitiveness and austerity measures. At the same time the EU’s crisis-ridden member states in particular have pointed out that similar attempts to create stability with the help of risk sharing have not obtained the same kind of support in Germany. On the other hand, there was a widespread perception within the Federal Republic that in the crisis the country acted in a pragmatic manner and displayed solidarity in order to preserve the eurozone. In fact it is more or less beyond dispute that Germany became willing to accept reforms of the euro area that had previously seemed impossible in order to ensure the systemic stability of the currency. Without German support it would not have been possible to establish the ESM, the permanent rescue mechanism, or the Banking Union. Furthermore, the Federal Government accepted crucial ECB measures such as bond purchases within the framework of the Securities Markets Programme, which started in 2010, and the OMT programme (“whatever it takes”), which was unveiled in the summer of 2012. It did not use them to start a debate about the very existence of the monetary union. All in all these measures add up to an important reorientation of German policy on the euro.

4. An incomplete monetary union

In spite of the comprehensive reforms that have been introduced in recent years, the common monetary area has not as yet reached the point where it can be considered to be stable in the long run. Lower levels of government debt might manage to restore the confidence of the financial markets in the solvency of the eurozone countries, but they would not constitute a guarantee of stability. If another crisis were to hit the euro area in the near future, there would still be very little room for manoeuvre. And the euro area is not stable in

21. Jens Weidmann, “Eurokrise und kein Ende?,” Speech at the Industrieabend des Unternehmerverbands für den Kreis Gütersloh e. V. (Frankfurt: German Bundesbank, 23 September 2015); Wolfgang Schäuble, “Es ist wichtig, dass der Fiskalpakt Ende Juni verabschiedet wird,” *DIE ZEIT*, 21 June 2015.

22. Nicolas Verón, *Europe’s Radical Banking Union* (Brussels: Bruegel, 2015).

systemic terms either. It is true that the new supervisory and coordination methods make it much easier to detect private sector imbalances. However, the reasons why they occur are still the same. A heterogeneous economic area with a common currency calls for better and more robust coordination. The European Semester, which was established in 2011, is supposed to deal with the problem. However, there are doubts about its effectiveness, and its recommendations for reform are rarely implemented.²³ Furthermore, it continues to be a moot point whether the European Commission has the requisite political power to enforce adherence to the rules and coordination in the case of the large member states.

Since the ESM rescue mechanism is based on “several liability” and not on “joint and several liability,” a serious crisis could easily cast doubt on whether the eurozone countries were actually willing to share the risks. It is no coincidence that the worst crisis of the euro area first came to an end after the European Central Bank announced the start of the OMT programme in the summer of 2012, since this comes very close to risk sharing on the basis of joint and several liability, though under another name.²⁴

Furthermore, the undeniable absence of democratic control of the ESM could lead to more instability. Neither the rescue mechanism itself nor the troika which has been assigned the task of supervising the agreed adjustment programmes have any legitimacy on the European level that derives from parliamentary control. At the same time they have vaguely defined and ad hoc powers of a very far-reaching kind with which they can intervene in the national policymaking of the programme countries.²⁵ The resulting impression of arbitrary rule has led to protest movements in the crisis-ridden countries and threatens to undermine support for the EU in general.²⁶ It is difficult to encourage cooperation among the member states as long as a group of creditor countries is in a position to stipulate the political obligations of a group of debtor countries. There has been an undisputed trend in the crisis towards a more intergovernmental Europe.

The European Banking Union, despite its undoubted merits, is still incomplete. For example, a government debt crisis in the euro area can still have a disastrous effect on the national financial system through capital flight and the fact that many banks are dependent on the government bonds of their home countries.

At the same time the potential consequences of a return to national currencies are dramatic as far as trade, finance and the future of European integration are concerned. It is a path that only a minority wishes to pursue. This became especially apparent when the Greek crisis peaked in the summer of 2015. Although a great majority of the Greeks rejected the policy of internal devaluation, two-thirds of them wanted to keep the euro even when faced with the prospect of more painful cutbacks.²⁷

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In order to stabilize the monetary union in the long run it will be necessary to overcome the structural weaknesses of the common currency that still exist. Today Europe and Germany are faced with the challenge of striking a compromise between the interests of the nation states and those of the European level.

23. Servaas Deroose and Jörn Griesse, “Implementing economic reforms – are EU Member States responding to European Semester recommendations?,” *ECFIN Economic Briefs* 37 (Brussels: European Commission, 2014); Zsolt Darvas and Álvaro Leandro, *The limitations of policy coordination in the euro area under the European Semester* (Brussels: European Parliament, November 2015).

24. Henrik Enderlein and Jörg Haas, “What would a European Finance Minister do? A Proposal,” *Policy Paper* 145 (Berlin: Jacques Delors Institut – Berlin, October 2015).

25. Fritz W. Scharpf, “Political Legitimacy in a Non-Optimal Currency Area,” in *Democratic Politics in European Union Under Stress*, Olaf Cramme and Isabell B. Hobolt, eds. (Oxford: Oxford University Press, 2015), 19-47.

26. Klaus Armingeon, Kai Guthmann and David Weisstanner, “How the Euro Divides the Union: The Effect of Economic Adjustment on Support for Democracy in Europe,” *Socio-Economic Review* (2015), 1-26.

27. “Most Greeks want to stay in euro and reach a deal,” *Ekathimerini* (18 July 2015).

5. Constituent elements of a stable monetary union

In the area of economic policy the goal of the monetary union should be to prevent a recurrence of large macro-economic imbalances. Thus it is important on the one hand to synchronize the economic cycles of the economies in the euro area more closely than has hitherto been the case. This will enable the ECB to pursue a kind of monetary policy which is appropriate for the whole of the euro area and does not amplify upturns and exacerbate downturns. On the other hand, the euro area needs to reduce macro-economic imbalances at an early stage, and certainly before they reach a magnitude that can destabilize the currency union.

Completion of the internal market. A key role in both efforts is played by the free movement of goods and services in the euro area, which can correct changes in competitiveness at an early stage. In the services sector the internal market still has a long way to go. Moreover, it must also be made easier for workers to move from one national labour market to another and to take their pension entitlements with them. Furthermore, a cyclical stability mechanism could help to align economic cycles by redistributing money from countries in an upturn to countries which are in a recession.²⁸ For example, in the early 2000s such a mechanism would have attenuated Germany's economic downturn, and the overheating of the Spanish and Irish economies. A European unemployment insurance system would perform a similar function. However, it is controversial on account of its far-reaching political implications.²⁹

Simpler indicators. The success of these measures can be measured with the help of surveillance mechanisms such as the Macro-economic Imbalance Procedure. However, this is still a very complicated affair that leaves a lot of room for interpretation, and makes communication rather difficult. Reducing all this to simple (though relevant) indicators such as inflation differentials, differences in nominal unit labour costs and the current account would make it easier to formulate a political response whenever difficulties are in the offing.³⁰

More risk sharing. A complete convergence of the European economies is neither probable nor necessarily desirable. Nor would it be sufficient in itself to forge a stable monetary union. However, there is a need for some kind of budget policy coordination. Yet there is a fundamental tension between individual nation states' claim to budgetary sovereignty and the interest of the monetary union as a whole in preventing the negative spill-over effects of excessive indebtedness. At the same time the euro crisis has demonstrated that without some kind of fiscal risk sharing the members of a monetary union are very much at the mercy of self-reinforcing crises.

Transparent and predictable crisis management. A stable monetary union should be able to give its members credible support and to tell them what this is going to cost with regard to sovereignty. In the current ESM the answer to this is improvised in intergovernmental negotiations whenever an emergency occurs. This is politically dangerous, since it means that the welfare of the euro area is less important than the interests of individual member states. The ensuing delays are also expensive in economic terms. What is needed is a greater role for the Community method and higher predictability.

Better democratic controls. One possibility might be to give distressed eurozone countries access to jointly guaranteed loans. To what extent this curtails their sovereignty would depend on the degree of financial assistance, and would have to be defined beforehand. The supervision of such a system should be assigned to an individual who speaks for the whole of the euro area and is accountable to the European Parliament, the national parliaments, or to a committee made up of delegates from both. Thus the euro area would be stabilized in economic terms, and there would be democratic control of the crisis mechanisms on the eurozone or EU level. A function of this kind could be performed by a European finance minister.³¹

28. Henrik Enderlein, Lucas Guttenberg and Jann Spiess, "Blueprint for a Cyclical Shock Insurance in the Euro Area," *Studies & Reports* 100 (Paris: Notre Europe – Jacques Delors Institute, 2013), 1-79.

29. There is a good summary of the various unemployment insurance proposals in "Forum: Designing a European Unemployment Insurance Scheme," *Intereconomics* 49:4 (2014), 184-203.

30. Anna auf dem Brinke, Henrik Enderlein and Joachim Fritz-Vannahme, *What kind of convergence does the euro area need?* (Gütersloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin, 2015).

31. Henrik Enderlein and Jörg Haas, "What would a European Finance Minister do? A Proposal," *Policy Paper* 145 (Berlin: Jacques Delors Institut – Berlin, October 2015).

CONCLUSION: GERMANY AND THE FUTURE OF THE EUROZONE

Different perceptions of the central problem and different political preferences for the future of the eurozone have met head-on in the current debate about the long-term stability of the currency union. They are often reminiscent of the conflicts that accompanied the start of the monetary union. However, this is not the only reason why the reforms are making such slow progress.

First, the relationship between the euro area and the internal market has not been clearly defined. Can the degree of higher integration which is needed for the functioning of the euro be implemented within the institutional structures of the EU, or is there a need for separate institutions and mechanisms of legitimacy? How many non-euro countries are there going to be in the medium term? The referendum on a possible UK exit from the EU will have a profound influence on this debate, but will not solve the problem.

Second, most of the governments in the euro area are extremely reluctant to amend the European treaties. In the light of widespread scepticism about the EU many of them believe that the risk of losing a referendum is simply too high. However, it is doubtful whether an expansion of the parallel intergovernmental structures which came into being around the Fiscal Pact and the ESM treaty can do justice to the requirements of further integration steps, quite apart from the associated issues of efficiency and legitimacy.³²

Third, the German Federal Constitutional Court has imposed limits on moves designed to create a European fiscal union by pointing out that budgetary autonomy is a "basic legal element" of the monetary union.³³ Thus the Federal Republic is not permitted to accept unlimited liability for debt since this might nullify the budgetary powers of the German Bundestag. In subsequent rulings the court formulated its views in a more flexible manner. However, there is still a basic dilemma for policymakers committed to keeping budgetary sovereignty on the national level. What should they do in a situation where without a power transfer the euro would collapse, leading to insurmountable costs that would effectively curtail the very budgetary autonomy that they intended to protect?

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The compromises achieved during the crisis have demonstrated that, although Germany can exercise a veto in the reform process, it is not powerful enough in order to secure acceptance for controversial positions of its own. In some respects Germany was right to insist on rules and regulations and deficit limits. The negative repercussions of the over-indebtedness of a country indeed proved to be serious. However, the focus on limits to government borrowing was too narrow and it was not enough to rely on only one instrument, i.e. rules backed up by the threat of sanctions. Moreover, Germany and the other eurozone countries underestimated the interconnection between the public and private sectors and the vulnerability of countries which did not have a monetary policy of their own. In the course of the crisis German policy on Europe has become more pragmatic and adopted a more comprehensive concept of stability which encompasses crisis prevention and crisis management, and encourages a greater coordination of economic policies.

The euro crisis has clearly demonstrated the shortcomings of the Maastricht model. It is an inescapable fact that more changes lie ahead in spite of the reforms introduced in recent years. Formulating the steps of the

32. Nicolai von Ondarza, "Blocked for Good by the Threat of Treaty Change? Perspectives for Reform in the European Union," *SWP Comments* 50 (Berlin: German Institute for International and Security Affairs (SWP), November 2015).

33. German Constitutional Court (BVerfG), *Judgment of 7 September 2011 on the EFSF* (Karlsruhe).

reform process has always been a protracted affair, and occasionally its sluggishness has endangered the very existence of the monetary union. However, today Europe seems to have reached a point at which, as far as Germany is concerned, a greater mutualisation of risks is not on the cards unless more sovereignty is transferred to the European level. At the same time many other countries in the euro area, and France in particular, find this hard to accept. Since the financial markets are not making it imperative to take action, progress has come to a halt.

This is an extremely dangerous state of affairs, for the monetary union is still incomplete. Imbalances and recurrent crises are a characteristic feature of the common currency under the present framework. The difficult economic situation in many member states has led to declining approval for the European unification process and thus for the common currency. German policy on Europe should try to play a constructive role while there is still time. That is why it will have to answer the question of how much shared sovereignty and economic convergence are necessary in order to accept greater risk sharing in the common monetary union.

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