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MEMO TO MERKEL: POST-ELECTION GERMANY AND EUROPE

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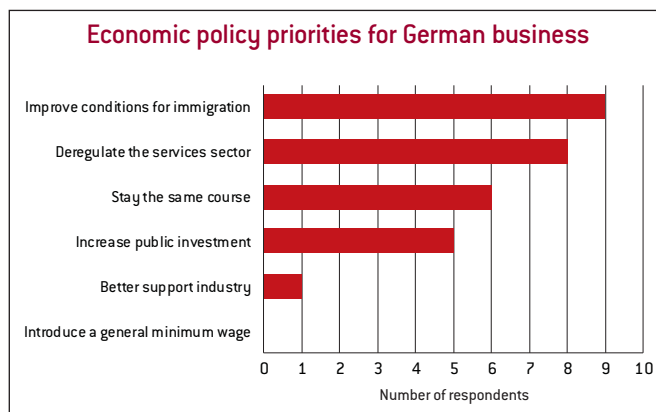
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THE ISSUE Recent economic data points to the seeds of an economic recovery in the European Union. However, significant risks remain and bold policies are still needed. There are three central risks. First, competitiveness adjustment is incomplete, casting doubt on the sustainability of public debt. Second, banking remains unstable and fragmented along national lines, resulting in unfavorable financial conditions, which further erode growth, job creation and competitiveness. Third, rising unemployment, especially among the young, is inequitable, unjust and politically risky. Germany has a central role to play in addressing these risks.

POLICY CHALLENGE

The new German government should work on three priorities: (1) Domestic economic policy should be more supportive of growth and adjustment, with higher public investment, a greater role for high-value added services, and more supportive immigration policy. (2) Germany should support a meaningful banking union with a centralised resolution mechanism requiring a transfer of sovereignty to Europe for all countries including Germany. (3) The establishment of a private investment initiative combined with a European Youth Education Fund and labour market reforms should be promoted.



Source: Bruegel-SWP German business survey. See Figure 2.

Building on these priorities, a significant deepening of the euro area is needed, with a genuine transfer of sovereignty, stronger institutions and democratically legitimate decision-making structures in areas of common policy.



THE EURO AREA: INCOMPLETE ACHIEVEMENTS

Recent economic recovery in the euro area feeds the belief that the sovereign debt and banking crises are finally over. The combined efforts of the European Central Bank and euro-area member states have resulted in major stabilisation and less financial stress.

But the situation remains unsatisfactory. Financial fragmentation makes it impossible for small and medium-sized companies in some, mostly southern, euro-area regions to access affordable credit. Meanwhile, relative price adjustment is insufficient. If prices fall and the economies of crisis countries stall or even shrink, the sustainability of their public debt will be brought into question again. A further round of crisis might set in and could make new and larger programmes or sovereign default possible (Box 1).

Though there are still major risks, the euro area has made progress. Since the beginning of the crisis, euro-area member state governments have combined acute crisis management, for instance installing the rescue mechanisms, the European Stability Mechanism (ESM), with moves towards a reinforced euro-area governance framework, with the aim of preventing future financial, banking and sovereign debt crises.

For political and legal reasons, governments' response to the crisis has increasingly relied on intergovernmental elements. The most effective remedy, however, has been provided by a federal institution, the ECB. It was the

ECB's announcement of the OMT programme that successfully calmed the crisis in autumn 2012. The flip-side of the slump in market pressure has been a slowing of the crisis-led governance reform progress. Policymakers must now show strong leadership to move the euro area into the next phase of integration. The unsatisfactory financial, fiscal and socio-economic situation calls for further euro-area reform.

Germany, willingly or not, will be

central to the building of the future euro area. Its economic size, its role as the largest lender and its safe-haven status have increased German influence. Decisions that it makes or chooses not to make have consequences for the European Union and the euro area in particular. The German government (and parliament) has the power of veto over the design of rescue packages. Germany has also leveraged its domestic legal and political constraints to increase

BOX 1: RISKS FOR THE STABILITY OF THE EURO AREA

The banking sector remains weak with market-to-book values well below 100 percent, suggesting that markets are still nervous about the quality of banks' books. The forthcoming ECB asset quality review could be a crystallising moment for Europe's banking system. If governments are unprepared, a prolongation of the banking crisis, with subdued credit and investment, is possible.

Second, unemployment is extremely high and poverty is on the rise with dire consequences in a number of member states. Social protests, growing populism and the presence of extremist parties in parliaments can prevent reform or oust governments, leading to debt crisis. This is all the more a risk while the credibility of the crisis management set-up remains fragile. The way Cyprus was handled showed vividly how easily a mistake with major consequences can be made when decision-making processes remain fragmented and slow. Visible tensions in the Troika of the International Monetary Fund, European Commission and ECB, and inconclusive debates about debt restructuring, could add to market nervousness.

Third, the vulnerability of the euro area would radically increase if doubts about the ECB's OMT (Open Monetary Transactions) bond-buying programme fester. The German Constitutional Court is likely to rule on the compatibility of OMT with the German Constitution in October 2013. Capital outflows driven by negative expectations are likely to set in, bringing back the sovereign-debt crisis even without a deterioration of economic fundamentals, if the verdict is negative.

The assessment that the euro area remains vulnerable is shared by a number of German business leaders. Bruegel and SWP surveyed 24 chief financial officers and chief economists from major German companies and banks¹. Nine stated that the situation in 2013 is better than in 2012, while 11 thought that the situation is the same or worse (seven said the same; four said worse). The deterioration of the debt crisis, social unrest and banking instability are the areas of greatest concern for most respondents.

1. DAX 30 companies plus 10 banks. The return rate was 60 percent (24 of the 40 answered). We included several additional questions in addition to those reported here. Not all 24 returns answered all questions.



its bargaining power in the negotiations on governance reforms.

The new German government will face a double challenge when devising its strategy on the future development of the euro area. First, it will have to strategically balance its short-term national policy preferences with its necessary contribution to the further stabilisation of the euro area, which is in Germany's long-term interest. German domestic economic policies will need to contribute to rebalancing the euro area. Second, the further development of the euro-area governance and crisis management structures, especially in relation to banking and fiscal union, is in Germany's long-term interest because it will stabilise the EU, but it might entail short-term costs. However, if the euro area heads towards further deepening, which might require a change to the EU Treaty, the German government will have to fully engage in finding a compromise for the future architecture of the euro area that is acceptable to all member states. Given the growing tensions between governments, domestic social and political tensions in the crisis countries, and the rise of euro-sceptic groups in some member states, agreement on a new Treaty and subsequent ratification will require the German government to be prepared for true compromise.

The following three proposals would greatly reduce financial and political instability in the short and medium terms, and would make future reform of the euro area's governance structures easier.

REBALANCING THE EURO AREA: THE ROLE OF GERMAN NATIONAL ECONOMIC POLICY

One of the most important factors for competitiveness rebalancing and debt sustainability is the consistency of German economic policy with the needs of the euro area as a whole. The German economy makes up 28 percent of the euro-area economy, and German economic policy decisions therefore automatically have implications for the euro area. Prices and wages in the euro area dramatically diverged in the first ten years of Economic and Monetary Union, with prices in the south increasing more than average, while prices in Germany fell below the average. There has been some adjustment during the crisis, especially since autumn 2011. Core inflation rates in the south of Europe in the meantime have fallen to close to zero percent. Price dynamics in some southern countries have since undercut the euro-area average, which is a result of the deep recessions in those countries.

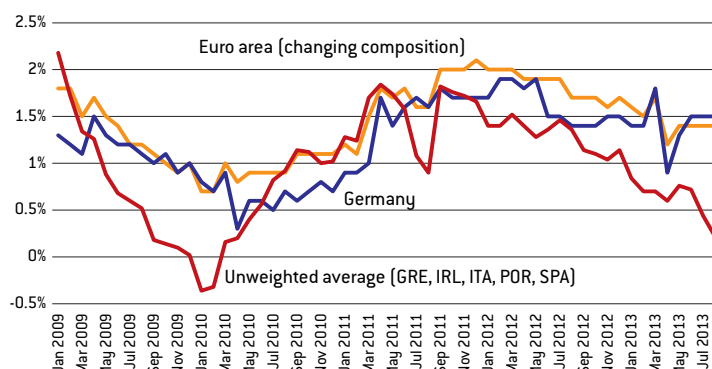
Meanwhile, German inflation rates, despite a strong economy

and low unemployment, have remained below average for most of the period and have only recently moved above the average. They have even been below the two percent inflation ceiling pursued by the ECB. Such low inflation rates in the euro area's largest economy make the relative price adjustment more difficult, because they eventually push the south towards deflation. The latest inflation data (Figure 1) shows that euro-area core inflation has been falling constantly since early 2012 and is now at close to 1 percent annually. Core inflation rates in the south of Europe in the meantime have fallen to close to zero. If prices fall and the economy stalls or even shrinks, debt sustainability becomes more elusive². Bigger support programmes for current and future crisis countries, or sovereign defaults, become significantly more likely in this macro-economic setting.

Three policies would help alleviate the rebalancing problem in the south.

The first is more domestic investment. Germany has recently

Figure 1: Evolution of core inflation (Jan 2009 – July 2013)



Source: Bruegel based on Eurostat, July 2013. Note: Core inflation is an inflation measure excluding volatile food and energy prices.

2. Zsolt Darvas (2013), 'The euro area's tightrope walk: debt and competitiveness in Italy and Spain', *Policy Contribution* 2013/11, Bruegel.



invested significantly abroad, but success has been limited. Most of Germany's net savings, ie current-account surplus, between 2006-11 was needed to cover losses on previous financial investments, according to Eurostat data. In other words, Germany's net external wealth hardly increased. Greater external stability would change this situation for the better for Germany, but arguably the most stable and least risky investments could be made in Germany itself.

A shift towards more investment could be triggered by an increase in public investment. Arguably, German public infrastructure is sub-optimal as a result of one of the lowest public investment rates in the EU. Investment in education has also been relatively subdued at 5 percent of GDP in 2012 (compared to 6.2 percent on average for OECD countries). The share of investment in education as a share of public spending is likewise low (10.5 percent compared to the OECD average of 13 percent) and more investment in education and research would also be part of an increase in public investment. Increasing the public (tangible and non-tangible) capital stock would raise private capital productivity, leading to more private investment, which would be followed by more labour demand. Given that Germany is close to full employment, this is likely to trigger two things: increased demand for workers from abroad and for higher wages. German industry would be forced even further up the global value chain. Higher wages, also boosted by better education and greater

knowledge capital levels arising from more public research investment, could lead to a restructuring towards the high value added services sector. Private investment and increased economic activity could be further promoted by more generous tax incentives for investment. Such a shift would help the rebalancing by opening up greater opportunities for lower value-added industry in southern Europe. Higher growth would increase demand for imports from southern Europe, while the increase in the relative price level would make southern European products more competitive.

Second, conditions for immigration into Germany should be improved further as part of a wider initiative to improve EU labour mobility. It is a positive signal that more people (369,000) came to Germany than left in 2012. More public and private investment could further increase the boom in the labour market, so corporations will increasingly have to look for foreign specialised workers. Such an increase in immigration would be an additional adjustment channel: instead of a change in the German production structure, immigration would allow current structures to remain but would reduce unemployment in affected countries. But immigrants do not necessarily have the skills needed. Specialised vocational training, language courses and more integration and language-support measures in German schools would be a useful investment for Germany and would facilitate labour migration from countries with high unem-

ployment rates. However, even a stark increase in net immigration to Germany would not solve the unemployment problems of southern Europe in a meaningfully short period, though they would help alleviate the pressure.

Third, the necessary rebalancing in the euro area would be crucially facilitated by a growing services sector in Germany. The new German government should very carefully review the sectors that are most regulated. Based on this, further liberalisation measures should be taken to allow them to grow³. While liberalisation might in the short term have a deflationary effect, the eventual increase in economic activity should overtake that effect. A liberalised services sector would also make German manufacturing more efficient and would represent a source of new jobs, including for immigrants. Of course, this would also shift the structure of German industry towards more services. At the same time, German growth would increase. Such a shift would also be associated with rising wages in Germany, which would further boost demand for foreign products.

Ultimately, the central factor will be that Germany does not resist a market-driven rebalancing of the economy. With the ECB aiming to keep inflation close to but below 2 percent, German inflation will have to move above the 2 percent threshold. It should be clearly communicated that this is not at all a softening of the ECB's mandate. On the contrary, the ECB would aim to keep euro-area inflation rates at 2 percent. The higher rate in Germany would merely be

3. One sector that may potentially lend itself to such a reform is the health sector.



a reflection of lower rates elsewhere. This increase in German inflation and wages will, however, have distributional consequences for German society, even though the country as a whole would benefit. Eventually, it will mean that the German economy will become much more than now an engine of euro-area growth.

These policy recommendations are broadly endorsed by German business as surveyed by Bruegel and SWP. While a significant number of respondents are content with current economic policy, those representatives of German corporations polled who see a need for change emphasise the importance of increased public investment, deregulated services and, most importantly, improved immigration conditions (Figure 2).

Rebalancing competitiveness in the euro area is necessary to ensure the sustainability of public finances in the crisis countries. The current strategy to put most of the adaptation pressure onto the countries running an external deficit has resulted in significant progress on reforms and wage flexibility in the south. However, the economic, political and social

limits of this approach have become obvious and the risk that political forces that argue for an end of reforms and austerity – inside or outside the euro area – become stronger is apparent. The approach should therefore be complemented by supportive policies in the surplus countries, as suggested here. The less-efficient and politically unacceptable alternative would be to install an explicit transfer system.

COMPLETING THE BANKING UNION

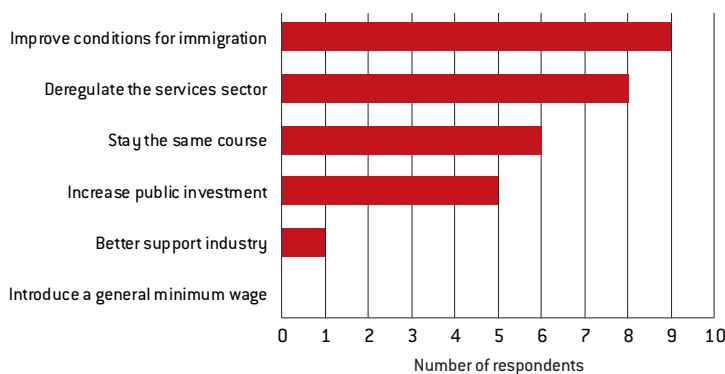
Completion of banking union should be the second priority for German policymakers. Solving the banking problems and ending the fragmentation of financial markets is the central element of a crisis-resolution strategy and a growth strategy⁴. Since the decision of the European Council of June 2012 to break the vicious circle between banks and governments, significant progress has been made. The Council and the European Parliament have agreed on the creation of a single supervisory mechanism in the ECB, which will be tasked with the direct supervision of all large banks in the euro area and in EU countries outside the euro area

that wish to join the mechanism. The ECB will also have overall supervisory responsibility for the entire banking system including the small banks.

But the creation of a single supervisor can only be the first step towards a completed banking union, which needs to be followed by a single resolution mechanism and an agreement on how to share the burden between private creditors, national taxpayers and a common fund. The political debate on those issues will be the central debate at the European level in the autumn of 2013. It is of central importance that Europe concludes those discussions in time for the ECB's asset quality review of the banks' balance sheets. A European resolution framework is needed for a number of reasons⁵. First, it is a way of protecting the ECB from pressure to delay triggering resolution and to keep insolvent banks with liquidity and Emergency Liquidity Assistance (ELA) afloat. Second, a European resolution authority is essential to ensure that bank failures do not result in major disruption of the European banking system. Third, if a resolution is needed, a European rather than a national solution is desirable to keep the financial market integrated. In particular, if a cross-border rather than purely national merger would make sense from a business perspective, it should not be prevented by the fragmentation of resolution authorities along national lines.

Three principles are central to burden sharing in the banking union. The first is to minimise the burden on taxpayers by involving private

Figure 2: Priorities for German economic policy



Source: Bruegel-SWP German business survey. Note: no. respondents highlighting each priority.

4. See Zsolt Darvas, Jean Pisani-Ferry and Guntram Wolff (2013), 'Europe's growth problem [and what to do about it]', *Policy Brief* 2013/03, Bruegel.

5. André Sapir and Guntram Wolff (2013), 'The neglected side of banking union: reshaping Europe's financial system', *Policy Contribution* 1013/13, Bruegel



creditors to the greatest extent possible without undermining financial stability. The second is that fiscal responsibility should in principle reside with those, who have (had) supervisory and broader economic policy responsibility. The third is that common fiscal support is desirable and also in Germany's interest if it can avoid forbearance or fiscal instability in affected countries and further fragmentation of the European financial market.

The precise institutional set-up of the European resolution mechanism is beyond the scope of this Policy Brief. As a guiding principle, it will be important that the mechanism can come to a decision on a bank in resolution in a relatively short period and that national considerations do not play a significant role in the resolution process. The creation of a common resolution fund appears indispensable for this, as does a decision-making mechanism that is not based on unanimity. This ultimately means a transfer of sovereignty because all member states could be overruled by the European level in a resolution process.

A PROMISE OF GROWTH AND JOBS, IN PARTICULAR FOR THE YOUNG UNEMPLOYED

National governments are primarily responsible for labour market policies and for addressing unemployment and youth unemployment. Germany should continue to demand – as it is doing – major reforms that will improve labour market conditions and increase the opportunities for businesses to grow and to become more com-

petitive. However, in a monetary union, there are not only multiple spillovers in the labour market but also limits to the power of national governments. Low economic growth resulting from a difficult adjustment process is one of the principle reasons for high unemployment. Private investment in southern Europe is extremely depressed by the weakness of bank and corporate balance sheets. Moreover, we have argued that insufficient growth in Germany further adds to the problem. There is thus an economic argument for the EU to be involved in solving the growth and unemployment problems.

There is also a strong political argument in favour of a credible initiative to tackle unemployment now. It would send a significant European signal of hope and recognition that the sharing of a single currency requires support for those most affected by the crisis. Such an initiative coming out of Germany would be a particularly strong signal for Europe's south, and would help curtail euro-scepticism which, in turn, will be one of the main obstacles to any further integration steps that are desirable. Citizens clearly need a message of hope. A banking union alone will not convince them of Europe.

The new German government should therefore accelerate support for private investment in southern Europe. In the short term, this should mean quick progress on lending to SMEs. A further initiative could be to provide tax incentives to German corporations that invest in the region. Increasing private invest-

ment in the region by ending financial fragmentation would clearly be of central importance to end the recession.

Additionally, a European Youth Education Fund should be established to back up the recently-decided measures on youth unemployment, which are clearly insufficient. Since the EU level has few levers to directly and effectively promote employment, a shift in emphasis towards education is warranted. The programme could finance education initiatives for young unemployed people throughout the euro area. Incentives would be given to firms for hiring and training young unemployed people. The programme would also provide funding for language training and stays abroad. It would thus improve the cross-border mobility of the young labour force and contribute to the building of a European identity, which is all the more important because it is being undermined by the economic, social and political effects of the crisis.

The initiative to re-establish significant private investment and to combat youth unemployment should be of sufficient size. The AAA countries and France should agree to increase European Investment Bank capital by €30 billion and accept that EIB activities would become heavily concentrated on the most affected countries instead of, as currently, being spread across the entire EU. They should also agree on a youth unemployment fund of €20 billion to fund training, mobility and work incentives. The support should be made con-



ditional on the implementation of national labour-market reforms.

GOVERNANCE REFORMS AND ECONOMIC OUTLOOK

By accepting the completion of banking union, the new German government would crucially contribute to stabilising the euro area and preventing a further deterioration of the crisis emanating from the banking sector. A reorientation of German economic policy would help rebalance the currency union and alleviate the profound economic, social and political crisis in some countries. Beyond its expected beneficial economic effect, a private investment initiative with an additional European Youth Education Fund would be a clear signal ahead of the European elections that the unemployment population is not forgotten amid the concerns about calming financial markets.

The combination of these three measures, which could be implemented at short notice, would prepare the political ground for further far-reaching reform of the euro area. Progress needs to be made in three areas: fiscal union including a euro-area budget, the establishment of stronger supra-national governance structures, and the democratisation of decision-making for when joint decision-making is necessary at EU level. While none of these areas can be fully covered here, we discuss the objectives of further integration in each area.

Fiscal union has *de facto* been launched by establishing fiscal control and sanctioning mechanisms to avoid negative spill-over

effects and by setting up the ESM. The opportunity is now to add further elements that will stabilise the euro area over the long-term and make public finances less vulnerable to violent market reactions. A euro-area budget could incentivise and support structural reforms in countries that respect the commonly-defined reform targets and in which tight budget constraints limit progress on reforms. Second, a euro-area budget could stabilise regionally diverging business cycles without representing a one-way transfer mechanism. While the completion of the single market, in particular to increase cross-border integration of labour and capital markets, would dramatically reduce regional business cycle divergences, a euro-area budget could help absorb very large shocks such as those of the current balance-sheet recession. Germany itself would have benefited from such a system in the early years of the euro area when as the 'sick man of Europe,' it suffered from economic slump and high unemployment while having to implement structural reforms.

A deepening of fiscal union requires the reform of the institutional set-up as a prerequisite. The principles to be respected when designing the institutional framework should be to increase the democratic legitimacy of decision-making, to minimise moral hazard and free-riding and to complement the assistance

approach by strengthening of market discipline. To this end, the euro area should be equipped with a sovereign default mechanism, which needs to be combined with risk weights on sovereign debt for banks. Such a sovereign default mechanism would be credible and would thereby allow market discipline to be reintroduced at an earlier stage when problems build up. In cases of clear insolvency, it would allow those problems to be solved by restructuring instead of relying on the community to pay for the private benefits.

Increasing the legitimacy of the euro area and the EU is a prime task for policymakers in the years to come. The euro area, and with it national decision-makers, have lost legitimacy in two ways. Economic performance and employment is weak in some member states and membership of the euro area is increasingly seen as a problem, rather than a solution. Meanwhile, there is a feeling that national elections and national decision-makers can no longer meaningfully influence the economic, financial and societal course a country takes. In order to stop support for the euro area eroding further, there is a pressing need to increase the legitimacy of the institutional set-up⁶.

One conceivable measure would be to strengthen the role of the European Parliament in the economic and fiscal governance of the monetary union by enabling it

'Contrary to the current approach, the sharing of sovereignty should be advanced by a strengthening of European institutions.'

6. Daniela Schwarzer and Richard Youngs (2013) 'Crises in the Euro Area and Challenges for the European Union's Democratic Legitimacy', *EuroFuture Paper Series*, German Marshall Fund, May.



to meet in a euro-area formation. This step would, however, imply that the current fiscal backstop, the ESM, be reorganised. The current logic of the ESM is that member states contribute and therefore national governments and parliaments have a veto right over all decisions. Such a unanimity mechanism, however, leads to sub-optimal outcomes from a euro area perspective. The ESM should evolve towards a European Monetary Fund with qualified majority voting, and which would be accountable to the European Parliament.

Such steps, however, would require the member states to embark on either a Treaty change or the creation of a new Treaty with an outcome that from today's perspective would be uncertain. First, there is a substantial danger that a further deepening of the euro area drives the non-members further away from the monetary union. This is particularly true for the increasingly EU-critical United Kingdom, which

moreover could use the opening of an intergovernmental conference on Treaty change to repatriate powers from the EU to the national level. An important future euro-area country such as Poland also could be driven further away from joining the euro area as every substantial step of integration pushes up the costs of joining. Neither is in the political or economic interest of the new German government. In our business survey, German business attaches a very low probability to a UK exit from the European Union (Figure 3). However, should it happen, the negative impact on German business is expected to be significant. So while it should be the priority for the German government to deepen the euro area by making it more resilient and democratic, this endeavour should be balanced with the objective of maintaining and deepening the single market.

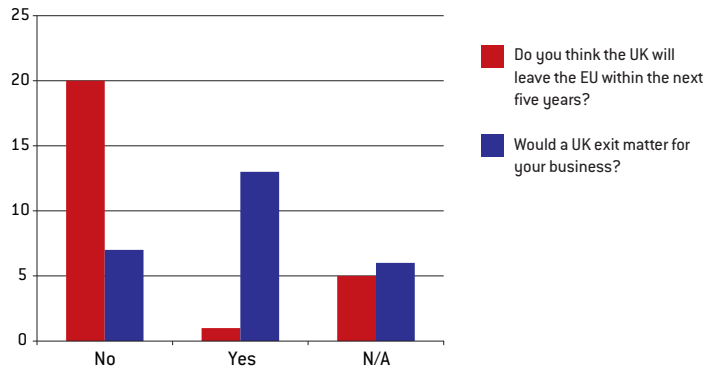
A second risk is a failure of negotiations or of the ratification of a new Treaty. To minimise the likeli-

hood of this scenario, any Treaty negotiations and the work of an eventual European convention should start with a very clear mandate, focussing essentially on euro-area related issues. In order to reduce the negative impact of ratification failures, the logic of the vote should be changed: if a country does not ratify, this should not stop the whole process, but the country would rule itself out of the next phase of integration of the euro area.

Germany is set to continue to play a central role in the development of the euro area. The general principle of combining support with the relinquishing of sovereignty is right. However, contrary to the current approach, the sharing of sovereignty should be advanced by a strengthening of European institutions, in which member states take decisions by qualified majority and the European Parliament by normal majority. The intergovernmental approach pursued in response to the crisis might have been the only option under severe pressure. It is, however, not in Germany's long-term interest to weaken the EU institutions or to cement the lack of EU-level democratic accountability and legitimacy. In an intergovernmental system, Germany would not only be the focal point of decision making, but also the focal point of political resistance.

A German version of this paper appears as SWP-Aktuell 55/2013.

Figure 3: The euro area and the UK



Source: Bruegel-SWP German business survey.

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