

Europe dances to Germany's tune

by Charles Grant

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For much of this year, the response of European leaders to the eurozone crisis has been hesitant and fractious. But when the European Council met in Brussels on October 28th and 29th, the EU appeared to be acting with greater purpose and sense of direction. One reason for this change is that most member-states – including France – are now willing to swallow large doses of German leadership. Chancellor Angela Merkel's influence was evident on the three key issues discussed by the summit: tightening rules on economic governance, setting up a new institution to deal with countries unable to borrow in the markets, and revising the EU treaties. However, Germany's leadership has also brought problems. One is that Germany's determination to get its way has bruised several smaller states, as well as the Commission and the European Central Bank. Another is that its reluctance to discuss imbalances within the eurozone has prevented the EU from taking serious action to tackle them – though the imbalances have (in the view of many countries) contributed to the euro crisis.

On the first key issue, the summit adopted the report of the task force led by Herman Van Rompuy, the European Council president, on *'Strengthening economic governance in the EU'*. The implementation of the report will mean stricter and more automatic punishments for countries that borrow too much, as the Germans – backed by the Austrians, Dutch, Finns and Swedes – have called for. Sensibly, the report says that the EU should focus not only on governments' budget deficits, but also the overall level of debt. The task force also considered the delicate subject of economic imbalances in the eurozone (the Germans do not like being told that their unwillingness to spend, and their current account surplus, contribute to inadequate demand and current account deficits in southern Europe). The report says it is more urgent to tackle imbalances in countries with big current account deficits than those in the surplus countries, but it does propose monitoring of imbalances and disciplinary procedures for all those who fail to act on recommendations to tackle imbalances.

On the second issue, the new institution, EU leaders agreed to establish a 'crisis resolution framework' to replace or supplement the European Financial Stability Facility (EFSF) that they designed last May to support governments unable to borrow in the markets. Merkel has been unwilling to prolong the three-year life of the EFSF, fearing that Germany's constitutional court could declare it in breach of the Maastricht treaty's no-bail out rule (she also knew that giving the EFSF a finite life would increase her leverage in the arguments on eurozone governance). EU leaders have not yet agreed on

how the new body will work, but it will probably be a kind of European Monetary Fund that both lends money (with strict conditions attached) and facilitates an orderly restructuring of the debt of countries that cannot repay what they have borrowed.

The Germans say this restructuring should lead to private sector creditors taking a loss, and many governments go along with that. But at the summit Jean-Claude Trichet, the president of the European Central Bank, and the leaders of some southern states – who worry about their ability to borrow – argued against establishing that kind of restructuring mechanism at this stage. It could deter investors from lending to eurozone governments, Trichet argued, and make it even harder for them to service their debts. The Germans responded that tax-payers should not bear all the cost of bail-outs, and that markets should fret about potential losses in order to discipline borrowers. The markets now seem to be doing that job – perhaps too well. Since the summit the cost of borrowing for the southern Europeans has risen to as high as it was before the EFSF was hatched in May (though the governments concerned started to tighten their belts several months ago). The Germans will face stiff opposition on the issue of creditors taking losses. But since they will be responsible for providing the biggest share of any rescue package, they are likely to win the argument.

On the third issue, treaty change, the summit asked Van Rompuy to report back in December on whether the current treaties need to be amended to establish the crisis resolution mechanism. The answer to that question is already clear. For many months the Germans have argued that treaty change was needed to ensure that a new mechanism did not fall foul of their constitutional court. However, most governments – having spent the best part of a decade sorting out the Lisbon treaty – did not want another round of treaty change. Then at the Franco-German summit in Deauville on October 19th, Merkel persuaded France's president, Nicolas Sarkozy, to back treaty change (in return for a modest weakening of some sanction mechanisms). At the European Council most other leaders followed them, if only grudgingly – though Luxembourg's Jean-Claude Juncker and the Commission's José Manuel Barroso argued against treaty change.

The heads of government now seem confident that a small treaty change can be achieved without too much pain. They have reached a tacit understanding to limit the change to the establishment of the new institution, and to rule out any other amendments. The Lisbon treaty contains a 'fast track' procedure that allows the heads of government to agree a change, by unanimity, without the need for a convention (the mix of MPs, MEPs and government representatives that drew up the constitutional treaty that later became the Lisbon treaty) or an inter-governmental conference. But two conditions must be satisfied: the change must not transfer powers to the EU, and it must concern the implementation of EU policies, rather than the fundamentals of the Union. The clause the Germans want should meet those conditions.

The fast-track procedure still requires each member-state to ratify the amendment. The Irish and the Danes seem to think they can avoid referendums. In the Netherlands, the populist Dutch Freedom Party and the left-wing Socialist Party are both threatening to demand a referendum, but they lack a parliamentary majority. In the Czech Republic, President Vaclav Klaus could create problems, as he did by delaying the ratification of the Lisbon treaty. In any case Czech eurosceptics are likely to challenge the amendment in the constitutional court, on the grounds that it gives the EU more power and therefore merits a referendum. Britain will not be affected by the new rules on eurozone governance, since it has an opt-out from treaty provisions on the euro. Nevertheless Conservative eurosceptics want Prime Minister David Cameron to block treaty change until the other member-states grant Britain new opt-outs from the treaties in areas such as social policy. Cameron seems determined to face down the eurosceptics. He will accept the amendment so long as other governments help him constrain the growth of the EU budget. At the moment France, Germany and about half the member-states are backing Britain's efforts to hold the rise in next year's budget to 2.9 per cent.

The Germans did not get everything they wanted at the summit. There was little support for their scheme to deprive governments that borrow too much of voting rights. They have had to accept the Van Rompuy report's argument that imbalances should be monitored. But the Germans achieved most of their key objectives. France had opposed stricter rules and quasi-automatic penalties for over-borrowed countries, a formal debt restructuring mechanism, and treaty change. But now it has accepted those German priorities – without appearing to get a great deal in return.

Visiting Paris just after the summit, I was struck by the deferential tone of some French officials when they talked of Germany. They noted that Germany is in a supremely self-confident mood because of its export surge to emerging markets. They thought this was not the right time to tell the Germans that their economic model was marred by a low level of domestic demand, and that that was aggravating the eurozone crisis. Much better to suggest gingerly that Germany would benefit from taking specific steps such as increasing investment and spending on R&D, lengthening shopping hours and getting more women into the workforce. Such steps would in the long term help to rebalance the eurozone. These French officials may be right on the tactics of how best to deal with the Germans.

In Paris, some senior figures fret about Germany's seemingly superior economic performance, compared to France and other EU countries, and about its economic structure – very focused on emerging markets – which seems to be diverging from that of its partners. "Will Germany lose interest in the EU?" they ask. For several years the French – and many others – have worried about Germany becoming less 'European' and more focused on the east, for example through its special relationship with Russia.

One French response is to stay close to the Germans in order to retain influence with

them. That has been evident in Russia policy: in recent years France has emulated Germany's soft approach towards Moscow (which is not to say that that policy is necessarily wrong). And that response has also been evident on the euro. At the Brussels summit several smaller member-states complained about having to fall in behind deals stitched together by Paris and Berlin. But so long as the French continue to back the Germans on eurozone governance, their partners – and the EU institutions – have little choice but to follow.

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