#BTW2021

DGAP MEMO

German Council on Foreign Relations

No. 02 | August 2021

(RE)POSITIONING GERMANY IN EUROPE

A New Roadmap for the Euro Area

Germany Has a Critical Responsibility to Advance Profound Reforms

By Shahin Vallée

The euro area is stuck between an incomplete currency union with profound structural instability and the political incapacity to devise a roadmap for its completion. Germany must help create a long-term plan to provide both economic and political stability to the single currency and the European project. The next German government needs a clear parliamentary mandate for reform and a coalition agreement aimed at constitutional changes in Germany and ambitious institutional and treaty reforms in Europe.

Despite radical shifts in the intellectual and political consensus of the 1980s and 1990s, the euro area's architecture has not evolved accordingly, leaving the single currency profoundly unstable. Reforms are gravely needed in Germany's next four-year electoral period.

The first 20 years of the euro have shown that Germany – echoing the Deutsche Bundesbank, its central bank – was probably right to insist that sharing a currency required a greater degree of political integration than agreed upon in the Maastricht Treaty. But the last decade has also proven that even thinking of letting a member state leave the monetary union can cause severe damage to not only the single currency but also, more broadly, the EU. The euro is both irrevocable and profoundly unstable. Thus, euro area integration will remain a central question of the European policy debate with profound consequences for a wide range of policy issues both domestic and European. Four main interrelated issues must be addressed to move toward a roadmap for repairing the architecture of the single currency:

1. **Overhauling Germany's and Europe's fiscal rules**
2. **Enhancing fiscal risk sharing at the EU level**
3. **Rewiring the European resolution framework for banks**
4. **Acknowledging the profound evolutions of monetary policy**

All these necessary changes will require a quasi-constitutional degree of institutional transformation. Germany must play a leading role in planning, negotiating, and delivering them. While these issues have largely been avoided during the current election campaign, voters and politicians must be clear-eyed about both the necessity and the requirements for putting the single currency – and, by extension, the EU – on more stable footing.

1. FISCAL RULES IN GERMANY AND EUROPE MUST BE REFORMED

As a response to the COVID-19 crisis, fiscal rules have been suspended across Europe. This has accelerated a long-standing debate about their fitness, and the European Commission has promised to make proposals for reform by the end of 2021. It is possible that France will use its presidency of the EU Council in the first half of 2022 and campaigning in the run up to presidential elections that spring to take a stand on this complex issue. In Germany, domestic debate over the *Schuldenbremse* – literally "debt brake" and colloquial shorthand for the constitutional rules to minimize federal borrowing – is inextricably linked to the wider debate about the European fiscal framework because Germany has played a central role in shaping both the European Treaty on Stability Convergence and Governance (TSCG)

and the reforms of the Stability and Growth Pact (SGP).

Today, there are two lines of thinking on this issue. The **first** considers the current set of rules to be an important anchor for fiscal policy and views constitutional reform as largely unachievable. It also argues that the rules are flexible – or at least malleable – enough, given that they can be suspended when needed. The **second** line of thought highlights that the rules have not only showed their limits in bad times, requiring their suspension, but also curtailed public and green investments in good times. Thus, it argues that more profound reform is warranted and amending Germany's constitution is not as difficult as it seems.

Indeed, since its constitutional amendment of 2009 that established the debt break, Germany has already altered the rules twice. Constitutional reforms were made in 2017 – as a response to the migration crisis – and in 2020 – to address the effects of the coronavirus pandemic – in an effort to provide more flexibility and allow for increased internal transfers. But despite these changes, debates about their reintroduction and evolution seem inevitable at both the German and European level. In fact, if these debates are not provoked by developments in Brussels or Berlin, they will be precipitated by those in Karlsruhe, seat of the German Constitutional Court. Indeed, the First Senate of the Constitutional Court recently issued an important ruling on the Climate Protection Act that opens a potential rift between the climate objectives of the German federal government and the *Schuldenbremse*. Against this background, Germany and Europe cannot avoid debating and reforming the fiscal rules. They must be made compatible with the public investment required by the EU's emissions reduction commitments; they must be adjusted to reflect the new public debt burdens; they must allow more effective stabilization in bad times; and they must be made simpler and more democratic.

2. EUROPEAN FISCAL INTEGRATION HAS ONLY STARTED

The debate on the evolution of fiscal rules is profoundly related to the extent of fiscal integration in the euro area. Over the last decade, the eurozone has taken several important steps toward its fiscal integration, namely, the creation of financial assistance mechanisms (the European Financial Stability Facility (EFSF) followed by the European Stability Mechanism (ESM)). More recently, it has agreed to the large issuance of common debt and the underwriting of cross-border transfers associated with the Recovery and Resilience Facility (RRF). While the euro crisis allowed for the creation of a permanent rescue mechanism, the COVID crisis has shown the limits of this approach. Indeed, the ESM is inadequate in the case of a shock that requires concurrent borrowing by multiple countries. In addition, the stigma associated with its use is such that many member states are reluctant to apply for financial assistance.

Because this calls the future of the ESM into question, one should think of more substantial reforms than the one undertaken in 2020. In particular, the possible transfer of the ESM to the European Commission should be considered in order to put all of the EU's borrowing power under one roof as well as under community law and the democratic control of the European Parliament (EP).

The COVID crisis has, however, caused two important developments that are worth exploring as potential avenues for long term fiscal integration:

First, the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) works as a borrowing facility to finance unemployment insurance in individual member states. It can be viewed as either a transitory stopgap to be used only in moments of extreme crisis or, alternatively, as the first step toward establishing a supranational scheme that would offer all European citizens a standardized basic unemployment insurance that is portable across the EU – ideas that were once studied by Germany's Federal Ministry of Finance but eventually shelved. Such a bold proposal would certainly require treaty changes, but it would create the first set of social rights and financial claims by individual citizens on the EU. It would mark a considerable leap forward in European economic and political integration.

Second, a July 2020 European Council agreement created common borrowing and centralized spending through the establishment of the Recovery and Resilience Facility (RRF). While the RRF was designed as a one-off instrument, its basic principle and architecture could be expanded and used toward other projects of common interest. A central feature of this plan is that it relies on new own resources (i.e., taxes) to back this common debt. While the German Constitutional Court enabled the ratification of the own resources' decision that allows these common resources, its final ruling on the conformity of the RRF with the European Treaty has not yet been issued. To a large extent, this ruling will determine the contours of a possible fiscal union, thereby clarifying the legal obstacles that must be lifted to make such a central fiscal capacity permanent. The German Constitutional Court may not rule for another year and is likely to transfer part of the case to the European Court of Justice. Therefore, German politicians might be tempted to avoid this debate altogether. But the reality is that the future of fiscal integration *will* stay a pressing question of their parliamentary mandate. Decisions by either court may set out legal challenges to overcome, but they will not settle the political choices that

must be made. Thus, political questions related to fiscal integration must be addressed by Germany's next government. Because a coalition agreement will play a central role in framing the European agenda, this agreement must be clear on the timing, scope, and conditions for fiscal integration and institutional reforms.

3. REWIRING THE EURO AREA'S RESOLUTION AND SUPERVISION FRAMEWORK

Over the last five years, while the EU has hammered on about the need to "complete the banking union," the financial integration agenda has made virtually no progress. In large part, this is because the roadmap prepared by the Eurogroup is ill designed. The EU does not need to complete its banking union by adding a common deposit guarantee scheme and changing the regulatory treatment of sovereign debt holdings as it is currently trying to do. Instead, it needs to entirely rewire the legal foundations of its common resolution approach. The combination of a weak Banking Recovery and Resolution Directive with an ineffective Single Resolution Board has left the EU incapable of resolving and/or restructuring its banks. Neither a common deposit guarantee scheme nor the poor arrangements being drawn to endow the Single Resolution Authority with a conditional fiscal backstop will correct this. Rather, a new approach is required.

The current focus of the Single Supervisory Mechanism (SSM) on balance sheet clean up might offer a more promising avenue. Undoubtedly, the creation of asset management companies or the discussions around the need for liquidity in resolution arrangements with the European Central Bank (ECB) or the changes to the State Aid framework for the financial sector will open areas for more structural reforms. The new German government could play a far more constructive role in helping a new roadmap to emerge. While creating the short- and long-term instruments to ensure that European banks can be cleaned up when necessary could avoid difficult issues in Germany such as those surrounding a common deposit guarantee scheme, it will not avoid them all. Indeed, these reforms will also require changes to the current supervisory arrangement that leaves most of the German banking system largely outside of the direct supervision of the SSM. In addition, such reforms will most certainly force a profound review of the financial stability consequences of the national institutional protection schemes that create strong solidarity ties between networks for smalls banks. (In Germany, *Sparkassen* and cooperative banks are typically part of these institutional protection schemes.) As recent financial scandals in Germany show, it is ultimately in the country's interest to upgrade the supervision of its domestic financial system. Although it will be strenuously resisted by regional and local banking lobbies, a more ambitious and less parochial agenda in this area is necessary.

4. MONETARY POLICY WILL REMAIN A CONTENTIOUS POLITICAL ISSUE

Monetary policy has become a central question for the future of the euro area in large part because the neat boundaries among financial, fiscal, and monetary policy have blurred. This creates a lot of discomfort in Germany, where the idea of a simple operational framework (refinancing operations), a clear instrument (interest rates), and a single objective (price stability) has been shaken. This evolution has made the toolkit of the ECB more complex, forcing the inclusion of asset purchases and negative interest rates while de facto expanding its secondary objectives to encompass financial stability, climate change, etc.

These profound changes create a heightened degree of political, legal, and constitutional tension. Nowhere is this more evident than in the German Constitutional Court ruling against the ECB's public sector purchase program (PSPP) of May 5, 2020, which effectively ruled that not only the ECB but also the European Court of Justice were acting ultra vires. If the ruling had forced the Deutsche Bundesbank to withdraw from the program, it could have opened a fundamental rift between Germany and the euro area. Only a careful and astute yet politically volatile work-around avoided such an extreme outcome: The ECB offered more formal explanations for its asset purchase program, the German government stated that the Constitutional Court could not rule on European law, and the Deutsche Bundesbank sided with the ECB. Despite all that maneuvering, the ruling exposed the potentially explosive tensions that lie in the current monetary policy settlement.

Monetary policy will become an even greater area of tension – partly because of the broadening of the ECB's role and partly because of the legacy that owning large stocks of government debt will create. One must accept that there is no going back to the status quo ante. The "normalcy" of the late 1990s and early 2000s may just as well have been an exception to the norm rather than the norm itself. Fiscal and monetary policy must cooperate much more intensely; absolutist, rigid rules around independence must evolve. This will require important debate and profound legal changes – including possibly to EU primary law – to grant the ECB a more solid legal basis for financial stability and to clarify the importance of the ECB's secondary objectives, especially with respect to climate change. The Central Bank of tomorrow will not be the Deutsche Bundesbank of the 1970s. These important choices cannot be outsourced to the Constitutional Court and will require open debates about the future of monetary policy and a new political settlement – in Germany and at the European level.

A NEW ROADMAP AND TREATY REFORM IS NECESSARY

The architecture of the euro area needs profound reform. In 2012, European heads of state and government accepted its limitations and requested a roadmap for change that was prepared by the "four presidents" of European institutions. This roadmap has, at best, only been partially followed. Further integration of the euro area's banking and financial system has been abandoned midway; fiscal integration has taken an inadequate "last resort" form of financial assistance; and while fiscal risk-sharing and transfers have indeed taken a leap forward during the COVID crisis, these gains may only be temporary. Last but not least, the political integration and democratization of the euro area has not progressed whatsoever. In the meantime, the United Kingdom has left the EU, the euro area has expanded, and the deepening of integration has taken shape in the EU-27 format rather than by way of intergovernmental arrangements exclusively for euro area members. Taken together, these realities have profoundly altered the framework for action.

The European Commission has announced a comprehensive review of European economic governance, and the European Parliament has just issued an own initiative report on the matter. Still, the reality is that there is limited political support for and consensus around an ambitious and long-term reform agenda. The Conference on the Future of Europe announced in 2019, which could have been an unprecedented opportunity to launch an institutional debate and treaty reform agenda, is unlikely to deliver.

This relative void puts a lot of responsibility on France and even more on Germany. By virtue of holding elections in the coming months, France and Germany have a responsibility to drive the development of a new roadmap. In 2017, France and Germany embarked on a set of bilateral discussions that culminated in the Meseberg Declaration of June 2018. But this effort was neither endorsed by the rest of the European Council nor has it been met by bilateral action. Germany's inaction is largely due to a coalition agreement that did not give the federal government a clear mandate. The next coalition agreement will therefore determine whether a repeat of the previous impasse and frustrations can be avoided. It must avoid language that would undermine Germany's ability to engage and lead the necessary discussion on Europe's much needed institutional reform; and it must avoid escaping the issue altogether by leaving the next government without a clear line to take, resulting in political paralysis.

In summary, Germany's next coalition agreement must provide a clear mandate that enables a concrete roadmap that would start with short-term interpretative fixes; be enhanced by deep European legislative changes; be complemented by reforms of intergovernmental treaties, including the ESM and TSCG; and eventually be completed by important treaty reforms. Such a plan would require intense negotiations with European partners and take months to be agreed upon. Although it will then take years to implement, it will provide necessary direction and a commitment that Germany is prepared to do what it must to avoid the euro continuing to fail forward with each new crisis.

In this memo series, DGAP offers concise analysis of issues related to foreign and security policy that will shape the agenda of Germany's next legislative period. Each memo provides insight on how the new federal government and parliament can take advantage of opportunities and meet challenges as European and global dynamics grow increasingly complex. Topics include technology, climate, migration, the international order, security, and geo-economics.

These memos are an invitation to join us in an even more in-depth conversation about the German agenda.

For more information, please visit: ***www.dgap.org/en/dossier/btw2021***

DGAP

Advancing foreign policy. Since 1955.

Rauchstraße 17/18
10787 Berlin
info@dgap.org
www.dgap.org
@dgapev

The German Council on Foreign Relations (DGAP) conducts research and advises on current topics of German and European foreign policy. This text reflects the opinions of the author(s), not those of DGAP. DGAP receives funding from the German Federal Foreign Office based on a resolution of the German Bundestag.

Publisher
Deutsche Gesellschaft für Auswärtige Politik e.V.
ISSN 749-5450
Editing Helga Beck
Layout Lara Bührer
Design Concept WeDo
Photo © IMAGO / Ralph Peters

This work is licensed under a Creative Commons Attribution – NonCommercial – NoDerivatives 4.0 International License.