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Economic Governance in the Eurozone: A New Dawn?

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The European sovereign debt crisis was the first big challenge to the euro. After much initial doubt about the survival of the eurozone currency, the German Chancellor, Angela Merkel, and the French President, Nicolas Sarkozy, agreed on a joint Franco-German plan for the 17 members of the Eurozone to ensure the long-term stability of the monetary union. At the summit in Brussels on 4th February 2011, both leaders announced that eurozone governments would embark on coordinating their economic policies. According to Merkel, the goal of the "Pact for Competitiveness" was to harmonise the conditions of the national markets and systems in order to increase the competitiveness among the members of the eurozone. The present 17 members of the eurozone are asked to coordinate their tax, pension, labour, and budgetary policies. While the Pact includes the 17 members of the eurozone, Angela Merkel emphasized that the other 10 non-eurozone countries can join in what she called the "17 plus" Pact. Already at the time of negotiating the European Stability Mechanism in December 2010, the EU-president, Herman Van Rompuy, was given the task to draw up a permanent Financial Stability Mechanism by the end of March 2011. In consultation with other eurozone leaders of governments and head of states, Van Rompuy is to report back with concrete steps on converging national fiscal and tax policies.

That the stability of the euro was high on the agenda of both Berlin and Paris was the message Angela Merkel and Nicolas Sarkozy tried to get across at the Economic Forum in Davos in January 2011. Sarkozy warned investors betting against the European single currency. "Never, listen to me carefully, never will we turn our backs on the euro, never will we drop the euro" (NYT 27.1.2011). Angela Merkel in introducing the new economic governance mechanism unequivocally stated that "we defend the Euro not only as a currency, but as a political project" (Press conference 4.2.2011).

Despite strong initial opposition to the French-German proposal (particularly from Austria, Ireland, and Belgium), the "Pact for Competitiveness" is remarkable for several reasons. Germany has always resisted the French call for *gouvernement économique* at the EU level going back to the 1980s. As recently as March 2010, Angela Merkel qualified the French call for economic coordination during the negotiations for a Greek rescue package. Unlike France, Merkel insisted at the time that the package for Greece should only be granted as "ultima ratio". In return for accepting the strong language on monetary stability, Nicolas Sarkozy could claim partial victory in gaining support for better economic governance in the eurozone. But Merkel qualified her support for economic governance by insisting that she endorses only better economic governance. In fact, many media pundits at the time suggested that the German agreement to economic governance was a hollow promise given Angela Merkel's strong opposition to any economic coordination (Young/Semmler 2011).

The recent German-Franco "Pact for Competitiveness" raises several questions about the future institutional framework of the eurozone. Why has Angela Merkel made this U-turn and suddenly endorsed the need for macroeconomic governance at the Euro-level? Does the broad response of Germany and France to the euro crisis signal a deepening of institution building so that monetary union is finally accompanied by economic (if not political) union? Will it strengthen the EU Commission (community method) to retain the sole right to propose legislation as championed by Jacques Delors, a former president of the Commission, or would it strengthen the intergovernmental cooperation (union method) which would mean that economic governance is decided among head of states and government leaders? Most importantly, do France and Germany agree on the definition of economic governance, or does Merkel intent to force the deficit economies to follow Germany's disciplined monetary and fiscal example? The mere fact that Angela Merkel refused to discuss any details of economic convergence to boost competitiveness at the joint press conference on February 4th in Brussels indicates that differences remain between France and Germany in how they define economic convergence (FT 5/6 February 2011).

The stony road to the “Pact for Competition”

Looking back to the initial response to stem the sovereign debt crisis erupting first in Greece in 2010, then spreading to Ireland, Portugal and even Spain, the leaders of the eurozone reacted hesitantly, uncoordinated, vacillating whether to come to the rescue at all, making sure that the eurozone did not turn into a transfer union, emphasizing that the debt crisis was a home-made problem of the peripheral countries, that the crisis had little to do with the global financial crisis, and was not the result of the eurozone imbalances between deficit and surplus countries. Given these initial fragmented, uncoordinated and national policy responses to each new turn in the sovereign debt crisis, the question arises what has changed that made Germany finally join France in providing a more cohesive policy response to the eurozone crisis in 2011.

It is worth remembering that the rescue package agreed for Greece in May 2010 did not provide a mechanism to ensure the long-term stability of the eurozone. In addition, the debt negotiations were done in the absence of the European Commission. The rescue operation was an inter-governmental affair between government leaders and head of states in which the Commission and the European Parliament were side-lined. Rather than stemming the crisis through the “community method” involving the European Commission proposing a common framework to resolve the crisis, it was Germany who largely set the tone for how to resolve the crisis. Debt ridden countries were singled out for their culture of fiscal profligacy. The discourse surrounding the rescue operation focused on the lack of domestic discipline in the peripheral countries who supposedly lived beyond their means. No mention was made that the German and French banks, in particular the German WestLB and the Commerzbank in combination with French banks, were heavily exposed to Greek public and private debts. The rising government bond spreads between the core and the periphery offered high returns to German and French banks. In April 2010, the yields on 10-year Greek bonds went as high as 7.38 per cent widening the spreads over German bonds by 435 basic points and raising doubts over Greece’s ability to service its deficit. The cost of insuring against a Greek debt default reached thus record heights. As a result, the Greek sovereign debt crisis, as was subsequently the case with the Irish sovereign debt crisis, was as much a crisis of undercapitalized European banks. For Barry Eichengreen, the renowned European economic scholar, the appropriate answer to the sovereign debt crisis

would have been to endow the German (also French and UK) banks with sufficient capital so that they can withstand a debt restructuring rather than bailing out the debtor countries (Eichengreen 2010).

Instead of providing leadership for a joint eurozone response, German euro-politics focused largely on domestic concerns and was overly nationalist in tone. The German government argued, and had the support of most of the public behind it (62 per cent of voters reject further bail-outs, and 61 per cent support Merkel’s actions) that Germany did its homework by making production more competitive, rationalizing the labour markets and modernizing the social welfare system with the Agenda 2010, and made every attempt to balance the budget up until the financial crisis. Instead of reaping the benefits for these, quite often, painful efforts, Germans were now called upon to bail out the Greeks. It is not surprising that many analysts criticized Merkel for her Euro-scepticism. Whether Merkel’s hesitancy had to do with party politics of not wanting to confront the German voters with the prospect of bailing out Greece before a critical state election in North Rhine-Westphalia in May 2010, or whether the constraints of the Constitutional Court in Germany, which had previously set strict conditions in its rulings on various aspects of the Lisbon and Maastricht Treaties, were responsible for the slow response is open for speculation. Tony Judd, the recently deceased historian, argued that Merkel’s slow reaction had to do with her East German background. “Angela Merkel having grown up in the East does not appear to have the slightest understanding of the essence of the EU and the costs which are associated with its neglect” (*Die Zeit*, 12.8.2010:44).

Finally it was the pressure of the bond markets which forced even a recalcitrant Angela Merkel into action to agree to a rescue package, since the interest spreads among the eurozone countries started to destabilize the euro currency. Angela Merkel’s hesitant intervention between February and May 2010 was criticized, since it increased uncertainties in the eurozone markets and drove the CDS swaps and yields on government securities to ever greater heights. This drove up the final price of the rescue package (Fricke 2010). The crisis was momentarily stabilized with a rescue package in May 2010. A safety net of € 750 billion was put together by the European Union and the International Monetary Fund. The rescue plan consisted of € 440 billion eurozone-backed loan guarantees for stricken eurozone members raised by a newly created European Financial Stability Facility (EFSF), in addition a €

60 billion European Union balance of payment facility to raise debt by the European Commission using the EU budget as collateral, and € 250 billion loans from the International Monetary Fund. Berlin also passed an emergency law to permit the government to lend € 22.4 billion over three years as part of the eurozone rescue plan. The ECB also was given new powers to intervene in public and private debt markets, plus extra measures to boost eurozone bank liquidity, and to buy government bonds from indebted countries starting in May 2010, which the ECB had never done before and which was controversial even among some of the members of the ECB. This exceptional activity of the ECB had personal ramifications. Axel Weber, the head of the German Bundesbank, member of the governing board of the ECB and a possible candidate for the succession of Jean-Claude Trichet resigned from his position at the Bundesbank in February 2011 citing the disagreement within the European Central Bank over its crisis management which he considered outside the Bank's mandate. The rescue measures for the indebted countries were equally controversial in Germany across the political spectrum and resulted in a number of formal complaints to the German Constitutional Court arguing that the rescue plan breaks the "no bail-out plan" of the European treaties (Sinn 2010: 10).

While the Eurozone leaders took their time to respond to the sovereign debt crisis, the national debt and budget deficit ratios in terms of GDP skyrocketed in the so-called PIGS countries (Greece national debt increased to 130 per cent and the budget deficit to 8 per cent of GDP; Ireland debt ratio increased to 94 per cent and the budget deficit to a horrendous 32 per cent of GDP, 10 times the Maastricht criteria of 3 per cent; Portugal which may still become the next default candidate has a national debt of 83 per cent and a budget deficit of 7 per cent of GDP). Ireland finally had to be bailed out by the EFSF in November 2010. In response to the Irish crisis, Angela Merkel insisted that the rescue in the amount of € 85 billion for a period of three years had to be embedded in a broader strategy to set-up a new bail-out system for future defaulting countries, to strengthen the Growth and the Stability Pact by enforcing fiscal discipline, to introduce a permanent crisis mechanism with stringent conditions, and to involve private investors after 2013 in the event of a sovereign debt crisis. Her untimely demand to involve private bold holders in any losses incurred as a result of the sovereign debt after 2013 frightening the bond markets, increasing the interest rates even further Ireland and other peripheral countries had to pay on the capital markets. As a result, the sover-

eign debt crisis worsened. Even her supporters such as the CEO of Deutsche Bank, Josef Ackermann, called Angela Merkel's remarks "very unfortunate". (Die Zeit-Online 6.12.2010a). In response to these massive critiques levelled against Germany, Wolfgang Schäuble, the German finance minister, argued in the Financial Times that the financial markets do not understand the specific construction of the euro. "We have a common monetary union, but we don't have a common fiscal policy. We need to convince the international public and international markets that this is a new form, very specific to meeting the demands of the 21st century" (Schäuble, FT 6.12.2010: 3).

Up to late October 2010, Germany rejected the notion that the stabilization of the monetary union needed more than stringent fiscal discipline. The problem of the sovereign debt countries was squarely seen in the fiscal profligacy of the peripheral countries. A puzzle remains why Germany focused on public debt as the culprit of the sovereign debt crisis. It was private debt in Spain and Ireland that was the Achilles heel of the sovereign debt crisis. Both Ireland and Spain had solid fiscal positions until the state had to bail out the banking system (Dodd 2010). Thus focusing on measures to enforce a more stringent Stability and Growth Pact targets only such countries as Greece but not countries whose debts are the result of the private banking sector.

Despite these rescue efforts, the markets remained unimpressed. Once again Angela Merkel and Sarkozy met to negotiate a mechanism to safeguard the financial stability of the eurozone. The result was a horse-trade agreed upon in Deauville in October 2010. Merkel insisted on strict fiscal discipline and thus suggested automatic punishment for those violating the Stability and Growth Pact. France was against this automatism, but in return Paris agreed on amending the EU treaties to create a permanent mechanism involving private creditors. The treaty change was necessary so that a permanent crisis mechanism could be enacted. The draft of a permanent stability mechanism was announced by the European Council on 17.12.2010. Under the leadership of Herman Van Rompuy, the European Council president, two essential elements were introduced. First, a permanent liquidity facility (the European Stability Mechanism) was created to replace the present European Financial Stability Facility put together during the Greek crisis in May, which expires in 2013. This new ESM is to help indebted countries with severe cash flow problems. However, Angela Merkel rejected at that time to raise the ceiling of € 440 of the present fund, and insisted that the

crisis mechanism can be triggered only as a last resort based “on a stringent programme of economic and fiscal adjustment and on a rigorous sustainability analysis conducted by the European Commission and the IMF, in liaison with the ECB”. Any assistance has to be decided unanimously by the Eurogroup Ministers (European Council 2010: 6-9). Second, standardized and identical collective action clauses (CACs) will be included for all new euro area government bonds starting in June 2013. This means that if a government is unable to service the debt, it will allow all debt securities issued by a Member State to be considered together in negotiations, including those who disagree with the majority vote. This is a legally binding change to the terms of payment and includes standstill, extension of the maturity, interest-rate cut and/or haircut in the event that the debtor is unable to pay (European Council 2010).

To enact these changes, a paragraph was added to Article 136 of the Treaty on the Functioning of the European Union (TFEU), which said: “The Member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality” (European Council, 2010: 6). In addition the European Council agreed that Article 122(2) of the TFEU will no longer be needed. The government leaders will meet in March 2011 for the formal adoption, which will then have to be ratified by the 27 EU member states. The permanent crisis mechanism will come into force on 1 January 2013 (Young/Semmler 2011). Germany’s insistence on fiscal discipline in these negotiations, Merkel’s refusal to raise the debt ceiling of € 440 billion, and in particular her unequivocal rejection of the Luxembourg-Italian proposal for jointly guaranteed Eurobonds to help finance the indebted countries within the eurozone led to angry attacks against Germany. Jean-Claude Juncker declared in a *Die Zeit* interview that Germany “thinks a bit simple, is un-european in how it handles business at the European level, and designates certain discussions as taboo-zones” (*Die Zeit*-Online 8.12.2010).

If the Germans had intended to calm the bond markets in the eurozone with the announcement of a permanent crisis mechanism and stem the harsh criticism against the discipline imposed on euro Member States, they were wrong on both counts. The crisis has stabilized, but Greece, Ireland, Portugal, and Spain are suffering from severe budgetary cut-backs, reduction in economic

growth, and social unrest. There is much speculation that at least some countries will have to resort to debt restructuring, since the indebted countries will be unable to service their huge debts. Nor have the critical voices against Germany subsided. Martin Wolf’s headline in the *Financial Times*: The Eurozone needs more than discipline from Germany, (22.12.2010: 9) sums up the feelings of many economists and political leaders even within Germany. The former German foreign Minister and Germany minister of finance, Frank-Walter Steinmeier and Peer Steinbrück, argue that Germany has become increasingly isolated within Europe by insisting on a “German Europe” rather than a more “European Germany”. (FT 15.12.2010). Tough fiscal discipline with limited emergency funding at high interest rates, and draconian domestic adjustments is a cure which most believe will kill the patients. Surely the question is whether “voters in Ireland, Portugal, Greece or Spain tolerate a decade of austerity just to stay in a union with Germany” (Münchau, FT 20.12.2010).

Economic Governance: A new dawn for the Eurozone?

Two months after the ink had barely dried on the draft of the permanent European Stability Mechanism, Merkel and Sarkozy announced the “Pact for Competition” to harmonize economic governance in a joint press conference on 4th February 2011. The question is whether this is a break with the past fragmented, national-oriented, uncoordinated piece-meal response to the turmoil of the eurozone markets. Surely, the mere fact that European leaders recognize that monetary union needs to be complemented with economic governance is a huge step forward. The present configuration of the European Monetary Union has a birth defect which was discussed at the time, but only came to full bloom during the sovereign debt crisis. Centralizing and transferring monetary policy to the European Central Bank, but leaving fiscal policy in the hands of national governments meant that macroeconomic coordination was sacrificed. This divided sovereignty (Jabko 2010) between the eurozone and national governments resulted in widely diverging economic and current account developments in member states. Unlike Helmut Kohl who reminded the members of the German Bundestag in 1991 that “(T)he Political Union is the indispensable complement to the Economic and Monetary Union. The recent history, and not just Germany’s teaches us that an enduring Economic and Monetary Union without a Political Union is not going to work” (Issing 2010: 3), Angela Merkel instead

defended the prerogatives of national sovereignty over tax and fiscal policy.

Given the stony road to resolve the sovereign debt crisis, the latest reform proposal, the “Pact for Competitiveness”, can be read as a new dawn for the eurozone. It signals that two very different ideas of economic policy making practiced in Germany and France may move closer together. In other words, it may lead to greater sovereignty for economic policy coordination at the EU level. Up until now two diverging concepts and ideas of economic policy-making have prevented macroeconomic governance at the eurozone level. Germany traditionally insists on the independence of the European Central Bank, a concept which is quite foreign to the French who have always advocated a more political influence for monetary policy at the ECB. Secondly, the German practitioners of the Social Market Economy put their faith in rules as the fundamental framework for economic policy-making. Thus while many euro-watchers may look bewildered at Germany’s insistence on exact rules for the Stability and Growth Pact or rules for a rigorous debt ceiling for the European Stability Mechanism, this rule-orientation has the intent to avoid political maneuverings over which Germany has no control. Thus it is not surprising that Angela Merkel has until now vehemently rejected the French call for more discretionary and political influence over economic policy.

Nicolas Jabko (2010) argues that since 2000 there has been some rapprochement between the French notion of *gouvernement économique* advocating a more active macro-economic management and the German notion of rule-setting. Particularly, the creation of the Eurogroup in 2004, which was an informal discussion group of the European finance ministers, headed by Jean-Claude Juncker, provided the first forum outside the formal decision-making body of the Economic and Financial Affairs Council (EcoFin) to arrive at common decisions. This nascent impetus of economic coordination received a strong boost when Nicolas Sarkozy saw the financial crisis as a window of opportunity to call for more economic coordination starting in 2008. As chair of the European Council, Sarkozy called for a “European Action Plan” to introduce a rescue plan for the European banking sector. In fact, it was Nicolas Sarkozy and Gordon Brown who initially led the rescue initiative at the EU level and not Angela Merkel. In the process, Sarkozy re-defined the concept so as to make it more palatable to the Germans. Jabko argues that from October 2010 onward, Sarkozy spoke of economic governance which he defined as “the coordination and peri-

odic steering of European economic policies by national political leaders” (Jabko 2010: 33). Shifting from the stronger *gouvernement économique* to economic governance means that no new transfer of power to the EU-level is involved. Thus it is not surprising that Angela Merkel at the press conference introducing the “Pact for Competition” on the 4th February reiterated time and time again that economic coordination does not imply “new competence for Europe”. According to Angela Merkel, economic coordination means that heads of state and government leaders would coordinate their economic decisions, which would need the approval of national parliaments.

That the media pundits and analysts immediately criticized the “Pact for Competition” as moving away from the “common method” of the EU and toward the “union method” in which head of states meet to coordinate economic policy is understandable. José Manuel Barroso, the Commission’s president, in a muted response criticized the idea that no additional competence was granted to the EU to solve the debt problem. He reminded the government leaders that the EU treaty provides the right framework for coordination. Critics are also correct in pointing out that the Pact has the strong handwriting of Germany. Insisting on a constitutional amendment for a debt-brake in each eurozone country to control public borrowing (as Germany has done to take effect in 2016) surely signals that Germany continues to believe that the sovereign debt crisis is the result of a lack of fiscal discipline. Only a rule-based constitutional amendment can, so the German argument, ensure fiscal prudence throughout the eurozone.

That Germany tries to imprint its stamp of economic governance on the EU is not surprising given the asymmetry of power between creditor and debtor states. As Kenneth Dyson (2010) pointed out the power over ideas in how to solve the euro crisis and the power in shaping the outcomes lies with the creditor nation and its belief in euro rules to safeguard the principles of the stability of monetary policy within the ECB. The “EMU was designed around ‘sound money’ and ‘sound finance’ ideas that were German in origin” (Dyson 2010: 604). What is new is that Germany is no longer outright rejecting economic and fiscal governance at the eurolevel. Not surprisingly Angela Merkel has defined the “Pact for Competition” according to German ideas. Despite the criticism from many member states to this German-French proposal, the Pact may turn out to be a watershed for macroeconomic coordination at the EU-level.

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