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Bridge over troubled water

Why the German-French engine is likely to stall

Not so long ago, Europe was in the dog-house. The financial crisis, staggering levels of unemployment in Greece and Spain, collapsing banks, Brexit, a new dawn for the far-right and unprecedented numbers of refugees escaping civil war in Syria and chaos in Afghanistan led many commentators to conclude the EU was on its last legs.

What a difference a year makes. With the exception of a few naysayers, European newspapers are tripping over themselves to exalt the Union's future. The German current affairs magazine, Spiegel, summed up the mood with the simple formula: Merkel + Macron = everything will be fine.

After Eurosceptics on the left and right lost to the pro-European Emmanuel Macron in France, hopes for a new start extended to the eurozone's unaddressed reforms. Since the euro crisis began in late 2009, repeated reform efforts have led nowhere thanks to major disagreements between member states. The last attempt in 2015 reinforced Germany's preference for the status quo of a "stability union" in which national economic policy is determined by rule-based free-market discipline. Demands for systemic corrections, fiscal policy instruments and risk sharing for the eurozone in a "fiscal union" went unheeded, as ideology continually trumped pragmatism.

Germany and France are key to bridging this divide. Macron's adamant demands for a fiscal union, along with his readiness to institute domestic structural adjustments demanded by Germany, are raising expectations that the two countries' different approaches to eurozone reform may at last be reconciled.

At first glance, the signs are positive. The German Social Democrats (SDP), along with German Chancellor Angela Merkel and German Finance Minister Wolfgang Schäuble (from the Christian democratic CDU), supported Macron during the election campaign. Both coalition parties were receptive to Macron's call for an investment offensive in the eurozone and a eurozone finance minister with a dedicated budget. A

German-French working group has been charged with drawing up proposals. At a French-German summit in Berlin, contradicting her finance minister, Angela Merkel no longer ruled out EU treaty change. Was it the risk of losing France to populists that moved Berlin to substantively accommodate its neighbour?

Reality check: words and deeds

Beyond the headlines, though, there is no real sign of change in Germany's euro policy. This intransigence is evident in negotiations over the latest tranche of the Greek bailout. In light of Germany's upcoming parliamentary elections, the central issue of debt relief for Greece has again been postponed. German procrastination has forced the IMF to reach a woolly compromise. The Fund stated the agreement exists only "in principle"; its further financial participation will depend on continued debt relief. But the Germans are sticking to their guns, insisting that if Greece learns to save, it won't need more debt relief. The latest loan agreement includes austerity measures lasting till 2060. Greece is also required to report primary budgetary surpluses of 3.5 percent of gross domestic product (GDP) by 2022.

Meanwhile, Germany continually shows itself unwilling to begin fundamental reforms. This spring it ignored the EU Commission's most recent initiatives formulated in a white paper and a separate paper on the eurozone – once again reminding member states that disagreement exists. Now calls are being made to solve the problem by the EU summit in December. At the European Council's June summit, reforming the eurozone wasn't even on the agenda. EU finance ministers also postponed instituting a banking union to safeguard retail deposits when Germany invoked its bugaboo, the mutualisation of risk.

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German negativity is further in evidence by the country's knee-jerk reactions to Macron's demands regarding the eurozone – once a Le Pen victory had been thwarted. Macron had barely won the presidency when CDU Finance Secretary Jens Spahn and the leader of Germany's liberal FDP Christian Lindner announced there should be no weakening of European deficit rules, such as allowing investments to be written off in order to finance bigger investments. CDU representatives promptly reminded President-elect Macron that mutualising debt is out of the question. During his inaugural visit to Berlin, they even

pushed him to declare he had never pushed for eurobonds.

The current framework reduces any European investment package to macroeconomic meaninglessness. The EU Commission posits (the politically unrealistic case of) all eurozone countries spending up to the debt limits stated in the Stability and Growth Pact: Additional investments would amount to less than 1.5 percent of the eurozone's economic performance in 2016 and remain below 1.7 percent of GDP until 2018.

Same terms, different vision?

There are many doubts about Germany's readiness to compromise on the roles, design and meaning of a common budget and finance minister for the eurozone. It sees things very differently to France.

Put simply, a government budget is able to levy taxes, take on debt and make expenditures. The French believe the eurozone needs a similar budget to balance out the macroeconomic repercussions from being tied to a common currency. Their view is that a joint budget would relieve a country's restricted fiscal policy, balance short-term economic cycles within the eurozone and strengthen long-term economic convergence.

Lacking any other sources of financing, such a budget would be a welcome stimulus for the economy, but still too small for any of the functions stated above.

Noting this, in January 2017, Macron demanded a common budget for the eurozone. Although he did not call for existing debts to be mutualised, Germany's blanket rejection makes it unlikely that there will be any joint bonds, not least because in 2012 Angela Merkel ruled them out for "as long as she lives".

New taxes at the eurozone level could also fill the pot. The often discussed EU-wide carbon tax would yield between €15 and 115 billion depending on the pro-tonne rate for greenhouse gases including carbon equivalents (between €2 and 39). That, however, represents a mere 0.008 percent of the EU's economic performance.

The most basic difference in views concerns expenditures. France is demanding changes to European fiscal rules and common borrowing because it needs to spend more on stimulus programmes, compensation payments and government investment. But this is probably not what

"joint budget" suggests in Germany: Given the CDU's notion of a stability union, fiscal policy is all about reducing debt, limiting expenditures and enforcing the rules.

The CDU views a finance minister as monitoring and approving the national budgets, pushing through competitive structural reforms and perhaps even offering financial payments to reward national savings. It does not hint at any willingness to seriously compromise on a fiscal union.

Lack of a real compromise could cause a crash

For all its talk, Germany has not changed its basic rejection of a "stability union" in response to the French president's demands. Merely mouthing the same terms does not mask the continuing differences.

Yet in the interest of sustainably reforming the eurozone, Germany should be more flexible with regard to France, whose latest presidential election showed Macron's predecessor what happens when Germans stick to their guns. Hollande's failure to make good on his promise to tone down Germany's austerity policies cost him a thrashing at the polls – and the extreme right-wing Front National threatening the EU's very existence.



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