E-ISSN 2014-0843
opinión
Europa

Centro de Estudios y Documentación Internacionales de Barcelona

150
JUNE
2012

Will Germany save the euro?

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In the 11th hour before the European Union's feared fall into the precipice, the German government has come forward with ambitious plans for more fiscal integration among the EU member states. The German proposals come as the Spanish banking crisis is threatening to bring down the Eurozone and spread contagion worldwide. The French and, in particular, Greek parliamentary elections and government formation are expected to bring even more uncertainty.

The German Chancellor has spoken out for the creation of a European supervisory banking authority, and of a banking union. Merkel, however, remains fiercely opposed to a "bail-out light" of the Spanish banks, the option requested by the Spanish Prime Minister. The German government is set to advocate more political integration on the European level – a "fiscal union" that would entail a more common budget policy, increased powers for the European institutions, and possibly also the creation of a "Ministry of Financial Affairs" for the Eurozone. The German Chancellor's plan would foresee a "two-speed" Europe in these matters, allowing the more ambitious countries to move ahead without waiting for those not yet ready follow the path. Although the exact contents of the proposal remain to be defined, media outlets report that she does apparently not want to stop at fiscal planning but wants to also push for a common European approach to labour market reforms, tax policies, and social security systems.

It has become evident to all involved that the mainly German-led policy of strict fiscal discipline and budget cuts is failing to achieve its aims. Structural reforms have not been enough to calm down the global markets and have also thrown deep into debt and into recession these EU countries that appeared financially sound before the failure to solve effectively the Greek crisis spread the storm across the Eurozone's. Almost overnight Spain has emerged as the Eurozone's biggest problem, on the brink of insolvency, threatening to spread contagion further to Italy and France and possibly even beyond. Germany continues to resist but may need to acquiesce under current international pressure, not least from the US, to accept mutual debt guaranteeing. Two main ways of achieving it are discussed. Eurobonds is an old idea, long touted by the federalists and picked up by the newly elected French president, and recently also backed by the Spanish government. However, the German Constitutional Court has made it clear that such a measure would mean a constitution change for the country, and may even need a referendum.

The second idea that is swiftly gathering support is a proposal by a German government's panel of independent economic advisors. They have proposed the creation of a redemption fund, a mechanism by which only the part of the government debt that is above the 60% of the GDP (the debt level deemed sustainable by the Stability and Growth Pact) would be mutually assured. The countries would need to undertake structural reforms and pay the debt back in 20-25 years. Since the mechanism would be temporary, it may not be unconstitutional and therefore may not prove problematic for the German Constitutional Court. Despite strong external pressure on the Germans to throw their weight behind a common debt guarantee mechanism, German political elites and the public remain sceptical, and stubborn in their agenda of imposing a more law-based, more Germanic structure on the EU.

The reasons for the German reluctance are multiple. There is a wide public understanding that the Southern countries have not played by the book and hence cannot be trusted not to fall into the old vices, should they be saved. Painful memories of hyperinflation run deep in the German national psyche and must not be underestimated. National obsession with low inflation is the reason behind the German insistence on a strong currency and on an independent Central Bank – the bases of its economic miracle after WWII. Further, one should not forget that the Stability and Growth Pact, that sets the basic conditions for the euro, was built in such a way that it would force the 'undisciplined' Southern countries to change their behaviour so that the Germans would never have to bail them out. This agreement is hard to break for the German political leaders when their voters strongly support austerity measures and do not trust the promises made by the leaders of some of the countries in trouble. Taxes are still not collected efficiently in Greece and the country's politicians continue to play a dangerous game of blame shifting with its public opinion. Spanish government's failure to report the real depth of the problem with Bankia, and to produce a credible estimate for the whole of its banking sector, as well as problems with spending by some autonomous regions, have further eroded confidence.

More integration is the best solution. It was proposed at the beginning of the crisis, where the problem was tiny Greece, a country whose economy accounts for less than 3% of the Eurozone's GDP. Had integration advanced then, the scenarios that we are facing now may have been averted. Nowadays, however, a number of countries find themselves vulnerable, for different reasons, and the German proposal may no longer be a workable short-term solution to the crisis. Firstly, because it does not have the support of the other net payers, most importantly France, who is unwilling to cede so much sovereignty to the EU. Secondly, such a proposal would inevitably need a treaty change. Any change to the European treaties would start a slow and cumbersome process of national ratifications, by national parliaments and even, in some cases, unpredictable referenda.

However, letting Spain, Europe's fourth biggest economy, sink and bring the whole Eurozone down with it for the principle of playing by the rules and being proven right is just plain short-sighted, not to say irresponsible. The European leaders are suddenly shaking off their tendency to procrastinating as events keep accelerating, but the current solutions may be not enough to snap out of the crisis. If a solution is not found swiftly, the strongest EU economies may find themselves in dire straits and even the ECB, which has bought up substantial amounts of national bonds, may find itself in trouble.

European leaders will meet yet again at the end of June. A vague commitment to more growth on the top of the fiscal pact will not be enough. Before trying to fully redesign the Eurozone's economic governance, the leaders need to find a quick solution for recapitalization of the banks in trouble and effectively calm the markets down (accompanied by adequate supervision mechanisms, naturally). Growth policies can only be achieved once the big crisis is averted and stability restored. While the long-term solution is definitely more fiscal integration, as proposed by the Germans, the immediate solution to the banking crisis may need to be an out-of-treaty option, such as the fiscal pact was.