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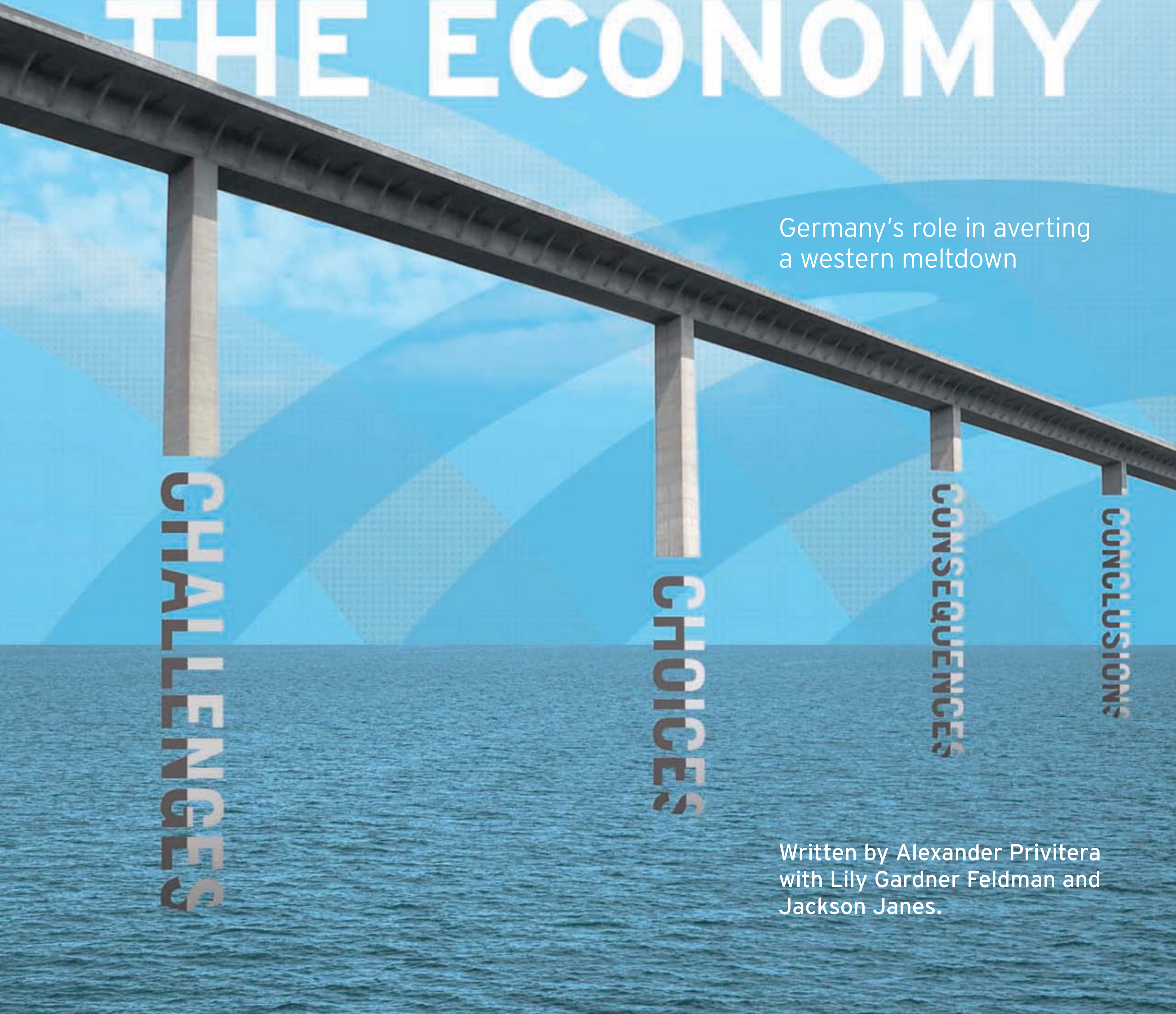
# IT'S NOT ONLY THE ECONOMY




Germany's role in averting
a western meltdown

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with Lily Gardner Feldman and
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ISBN 978-1-933942-36-0

**Additional copies:**

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# Foreword

**Since the first financial aid package for Greece by the European Union, European Central Bank (ECB), and International Monetary Fund (IMF) in May 2010, the euro system and its seventeen members continue to face severe challenges to overcome the European debt crises. The initial turmoil on financial markets and its contagion effect on other, mostly peripheral and southern, European countries severely disrupted investors' confidence in the creditworthiness of several euro member states and questioned the euro as a sustainable currency.**

The observed capital flows out of distressed countries into countries that are seen as "safe harbors" have in fact resulted in historically low yields of German and U.S. government bonds and helped the respective government budgeting. However, the current trading levels are unlikely to be sustainable and should not be interpreted as substantial strength but rather as interim relative strength in a very weak environment.

The governments of affected states and the euro community must nevertheless undergo fundamental social, economic, and fiscal reforms. This ongoing process has led in part to a downturn of most European economies with severe effects on fiscal balances and the global economy as whole.

September 2012 was packed with milestone events on both sides of the Atlantic, including the decision by the German Constitutional Court on the implementation of the European Stability Mechanism and the ECB's announcement that it would stabilize interest rates of European countries by allowing unlimited intervention in secondary government bond markets. In the U.S., the Federal Reserve Bank announced that it would initiate a third quantitative easing program to support the U.S. job market. Despite these events, many question marks remain around an ultimate solution, and the recently improved level of investor confidence remains very fragile.

In a series of online analyses, publications, and conferences, AICGS closely follows the developments of the European debt crisis and its implications for the German and U.S. relationship. Recent essays have touched on the decision in Karlsruhe, Merkel's leadership role, and the politics of central banking.

This publication features the highlights of AICGS' analysis: a compilation of insights into Germany's leadership role in overcoming the crisis and its effects on the U.S. economy, the 2012 presidential election, and the 2013 Bundestag elections. It examines the choices available to Germany—stabilize Greece, create a banking union—all within the confines of politics and public opinion.

The Institute's work on the euro crisis and its impact on the U.S. election would not have been possible without the generous support of The German Marshall Fund of the United States, the Alcoa Foundation, Carl Siebel, Roland Berger, Gebr. Heinemann, and the Delphi Foundation. Additionally, the Institute is grateful to the essayists and bloggers, who shared their insights and knowledge not only with AICGS, but also with our constituencies.

AICGS would furthermore like to thank Jessica Riester for her work on this publication.

I hope that reading this essay will provide you with new impressions, much food for thought, as well as pieces of useful information.

Jacques Brand

Managing Director and Global Head of Investment Banking Coverage
and Advisory, Deutsche Bank Securities Inc.
AICGS Chairman

# Overview: It's Not Only About the Money

For more than two years, the European debt crisis has helped America and Germany to overcome the consequences of Great Recession. Both countries, perceived as safe havens, have experienced significant capital inflows. Yields for their sovereign bonds have fallen. While credit conditions in the periphery of Europe have tightened, borrowing costs in the United States (U.S.) and Germany have gone down. Both nations have restored some level of confidence in their respective financial systems. Various unconventional steps undertaken by the Federal Reserve (Fed) (multiple rounds of quantitative easing and the so-called Operation Twist) have helped the U.S. stock markets weather the European storm. Overall, helped by robust growth in the emerging economies, and despite stubbornly high unemployment in the U.S. and growing frustrations about its anemic recovery, both the American and German economies have fared better than those of most European countries.

This pattern is not likely to continue.

Emerging economies, including China, are cooling down, and the economic crisis in Europe has worsened. The recovery in the U.S. is still fragile. Washington is facing its own set of challenges, compounded by the danger of falling off a fiscal cliff if members of Congress let current tax cuts expire and cannot agree on a new package of spending cuts and/or tax increases to reduce America's growing public debt burden. If no agreement is brokered by the end of 2012, draconian spending cuts will be automatically enacted across the board and the country will probably slip back into recession.

"Recent developments in the euro zone and in Germany, including in particular Chancellor Merkel's endorsement of the ECB's decision to buy bonds under certain conditions, against the strongly held view of the Bundesbank, could be seen as a turning point. The ECB's decision is certainly an important development in the EU that will take some of the pressure off the system."

—Amb. Wolfgang Ischinger
Global Head of Government Relations, Allianz SE
and Chairman, Munich Security Conference

At the same time, Germany's export-driven economy is finally starting to suffer from the consequences of the severe economic downturn in the periphery of Europe. Rating agencies continue to lower their outlook on Europe. Due to persisting uncertainties surrounding the political responses to the crisis, the International Monetary Fund (IMF) expects global growth to slow further in the coming months. For the first time since the eruption of the financial crisis in 2007-2008, the global economy could drift dangerously close to a global recession.

In order to steer away from this "perfect storm" brewing on the horizon, both German and American leadership will have to make some hard choices in the next few months, not only to preserve the health of their respective economies, but more generally to give the U.S. and Europe a sense of direction that has been lost in the crisis.

Taking the right steps will not be easy, not only because of the politics involved, but also because economists and policymakers still do not agree on the true causes of the debt crisis, let alone on the best way forward.

For some, the Great Recession is mainly the result of lax financial regulations, which led, they argue, to excessive risk taking by financial institutions. Congress tried to address these concerns with the Dodd-Frank Act in 2010, a 2,300 page behemoth that regulates the financial industry in great detail. Implementing the reform is proving to be much harder than expected. Some of its provisions, in particular the so-called Volcker rule (named after its author, former chairman of the Fed Paul Volcker), which bans proprietary trading by commercial banks, are still the subject of intense debate and negotiations in Washington. In fact, some of the critics of stricter financial regulation blame the crisis on a classic, albeit particularly hard, boom and bust cycle. They argue that markets will eventually find a way out of the current slump. They believe that overregulating the financial sector or other sectors of the economy will only be counterproductive and further weaken growth. In fact, the argument goes, it is precisely the growing role of government in the economy that has caused the crisis. Looking at Europe they see a generous entitlement system aching under a huge debt burden. They believe that cutting back on welfare spending will be necessary in the U.S. as well. Critics of this "light touch" approach strongly disagree. They counter that it is precisely in times of crisis that the government needs to step in, stabilize and stimulate the economy, and provide the spark to start growing again. We have witnessed this largely ideological debate, characterized by the media as a clash between austerity and growth, on both sides of the Atlantic.

But some have gone even further. They see deeper fault lines in the economies of the advanced countries and more profound structural weaknesses that have been exposed by the crisis. They look back and see a series of lost decades that led to the sudden, if not entirely surprising, conflagration. Some even believe that the dramatic downturn has in fact rattled the very core of the modern, globalized economy and the traditional principles of Western democracies. They point to rising inequality in Western societies, and fear that failing to correct the current economic order could hollow out long-held democratic principles. They argue that the challenge is both political and economic.

There is agreement on at least one fact: the era of the so-called "great moderation" that started in the early 1980s is over. Risk—and the fear of it—is back. The West has accumulated unsustainable amounts of debt and financial markets are expressing doubts about the advanced economies' capacity to pay it back. This uncertainty is compounded by a major global shift in the economic balance of power. Some have described this as a "No One's World," in which there is no hegemon and no consensus about a new order. They point out that the urge to react collectively to the crisis in 2008 through the G20, hailed as an enlarged committee to save the world, has been pushed aside by calls, both in the U.S. and in Europe, for more protectionism. The G20 has become a forum without a common agenda. Are we drifting toward an age of political and economic fragmentation?[1]





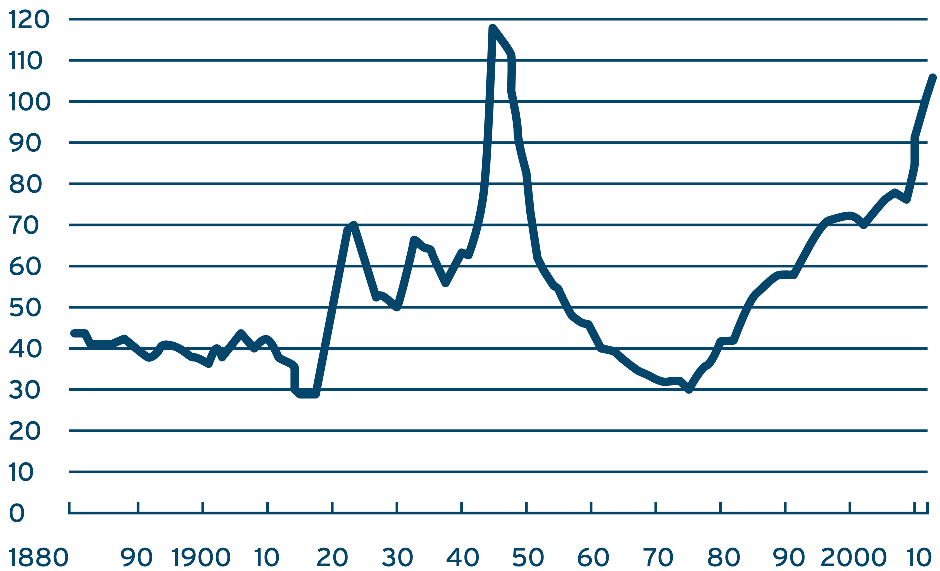
Some European leaders, worried by their own inability to tackle the crisis effectively within the existing European institutional framework, see the danger of a deep fault line dividing the north and south of the continent.[2] Others have pointed out that Europe's institutions lack the democratic legitimacy as well as the executive tools to address a severe crisis. Financial markets in Europe, integrated in a single market for the last twenty years, have started to fragment, forcing the European Central Bank (ECB) to take unprecedented

1 For further reading, see: Raghuram G. Rajan, *Fault Lines* (Princeton: Princeton University Press, 2010); Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press, 2010); Menzie D. Chinn and Jeffry A. Frieden, *Lost Decades* (New York: W. W. Norton and Company, 2011); Paul Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton and Company, 2009); Michael Spence, *The Next Convergence* (New York: Farrar, Straus and Giroux, 2011); Charles Kupchan, *No One's World: The West, the Rising Rest and the Coming Global Turn* (Oxford: Oxford University Press, 2012); Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, DC: Government Printing Office, 2011); Allan H. Melzer, *Why Capitalism* (Oxford: Oxford University Press, 2012); Carmen M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).

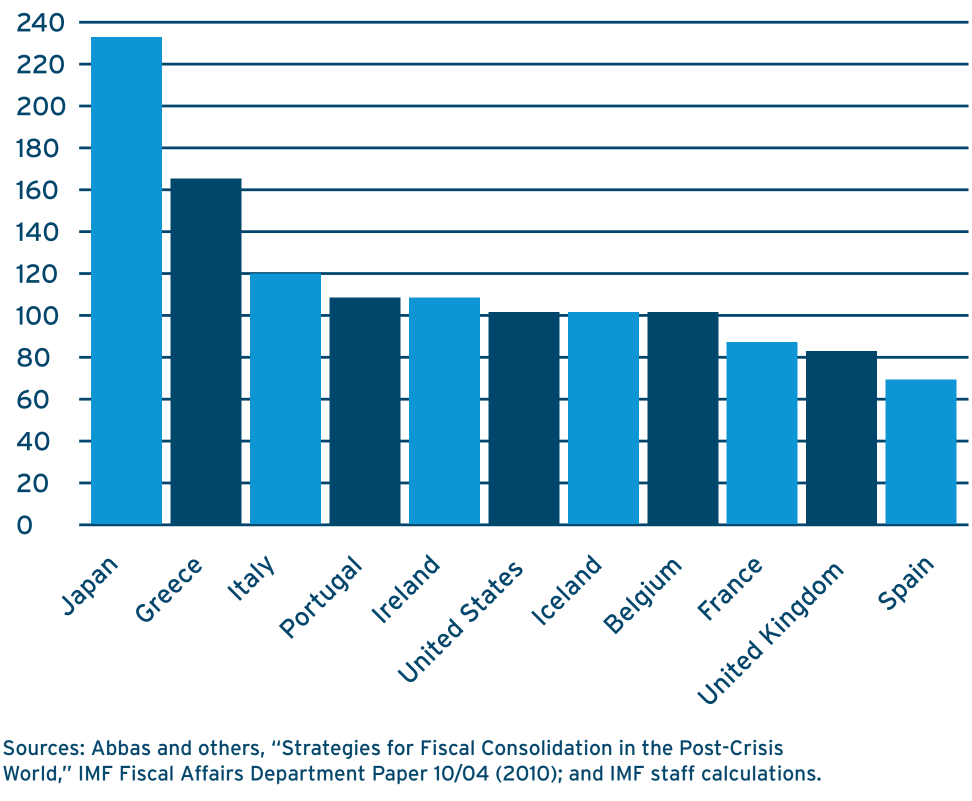
2 Italian Prime Minister Mario Monti has repeatedly publicly warned of the danger of such a dividing line emerging between the north and the south of Europe. See: Mario Monti, Italian Prime Minister, interview with German weekly Der Spiegel on 6 August 2012.

**Figure 1: Gross public debt as a percentage of GDP among advanced economies is close to historical highs, with many countries' ratios around 100 percent or more.**

Historical debt levels, 2011 U.S. dollar GDP-weighted average, percent




Debt-to-GDP ratios for selected economies in 2011, percent of GDP




Sources: Abbas and others, "Strategies for Fiscal Consolidation in the Post-Crisis World," IMF Fiscal Affairs Department Paper 10/04 (2010); and IMF staff calculations.

action. Despite the recent launch of a new bond buying program by the ECB, which has restored some market confidence in the short term, many investors are still unsure whether the central bank will be able to protect the euro zone in the medium term. Some German politicians fear that the European way of life could itself be in jeopardy.

### Europe has become a microcosm, grappling with questions that go well beyond European borders.

- Does a western set of values, a western model of society, still exist?
- How can the need for closer international integration, or at the very least cooperation, be reconciled with enhanced democratic controls?
- Are modern western democracies still capable of setting long-term goals and priorities that transcend short election cycles?
- Can further economic and political integration make the international system and Europe more resilient against sudden shocks?
- Is the debt crisis driving the continent apart? Could Europe emerge as a new source of global instability?

These are all legitimate questions. In a letter to investors at the beginning of 2012, Bank of America Merrill Lynch warned that, "We are all Europeans now." As we approach the end of the year, that is still the case. It is still in the strategic interest of the U.S. to keep the euro zone intact. If the euro fails, the European single market will in all likelihood crumble. If the single market collapses, the whole European project would be jeopardized. If the European Union fails, Europe will indeed once again be a source of political and economic instability. This is not a risk that any political leader would willingly take. However, in the absence of more significant steps toward greater, democratically legitimated integration, Europe could very well drift toward greater political instability.



The debt crisis in Europe has exposed democratically elected politicians' shortcomings and their reluctance to make difficult decisions. Central banks on both sides of the Atlantic have repeatedly stepped in to fill a huge political vacuum. But in so doing, they have stretched the limits of their mandates and become politically vulnerable. European leaders need to recognize that if they fail to address the underlying weaknesses of the euro zone by continuing to engage in an endless game of chicken, a partial or even total break-up of the euro area could very well occur. They should recognize that the worst case scenario has been averted only because the European Central Bank has repeatedly intervened. In fact, the ECB has become the real European architect of the rescue. Now, it is time for the political leadership to step out of its comfort zone.

In the fall of 2012, and despite recent decisions by the ECB and the German Federal Constitutional Court in Karlsruhe, Germany still holds the key to solving the crisis; thus, the primary focus of this paper will be on Germany. We will draw a roadmap and describe the hurdles that lie ahead. We will explore the way in which Germany is likely to behave. We will argue that if Chancellor Angela Merkel really wants Europe to succeed, the euro area needs to turn the corner in the next few months. We will outline the challenges that Merkel and the political leadership in Europe face in the coming months and describe the dangers of a continuation of the cautious step-by-step approach. We will lay out some of the practical choices and show what the consequences of action or inaction could be.

## Our key recommendations are:

- The need to consider a further significant haircut for Greece once the government in Athens finally demonstrates that it is capable of running a substantial primary budget surplus. In our view, it may be necessary for Greece to restructure the public debt held by the official sector, i.e., the euro zone countries and institutions such as the ECB. A well-managed, partial default by Greece, however, would not and should not trigger an exit from the euro zone.

- The need for a comprehensive deal on a banking union, preferably to be struck by the end of the year. An agreement on a banking union is not only a prerequisite for creating a framework capable of reversing and preventing further financial fragmentation within Europe; it is also the chance for Europeans to demonstrate their common willingness to move decisively in the direction of a more perfect Union.

Let us conclude by pointing out that, despite all the criticism, Berlin has repeatedly acted to avert a collapse of the common currency. It has been instrumental in trying to correct some of the birth defects of the monetary union and has put forward proposals for a closer Union. However, Germany has still not made the fundamental choice between a Europe that is simply more closely coordinated and one that makes decisive steps toward greater political integration. Germany's fence-sitting, and its polarized internal debate, coupled with its reluctance to provide more robust financial backstops in the short term, have helped to infect the markets with uncertainty, and have undoubtedly led to a worsening of the overall situation.

# American Exceptionalism: Time for New Thinking on Economics and Security

**Exerpts from Robert B. Zoellick's Alastair Buchan Memorial Lecture at IISS, London, July 25, 2012**

Since the end of World War II, the international economy has been marked by three phases: from the creation of the Bretton Woods system to its breakdown in the 1970s; then, a capitalist revival from the late 1970s through the end of the Cold War; and third, the rise of globalization in the 1990s, extending to the Crash of 2008. We are now stumbling into a fourth phase—one that is vital for us to shape.

[...]

Global financial capitalism—and our countries—face a new crisis: of credit, conduct, and even confidence.

After harsh blows, the advanced economies are struggling to reduce debt and revive jobs and productivity through structural reforms. Unemployment is up. Confidence is down. Protectionism is rising. Publics are anxious. Politicians are struggling.

Developing economies have been hit, too, although many have fared relatively better. The sixty year long leadership of developed economies is in question.

The relationship between economics and security is again the principal issue. The strategic and security stakes are high.

Will the euro zone and the historic success of Europe's peaceful integration survive—and with it, Europe's influence in the world? Will the middle income developing countries—some of which are rising powers—overcome the so-called "middle income trap" to become high-income countries and "responsible stakeholders" in the international system that has benefited them, but which they did not design?

Will the poorest—the "Bottom Billion"—have an opportunity to prosper too, or will they be breeding grounds for trans-national insecurities?

Will the new political systems of the Middle East and North Africa lead to new economic policies for inclusive growth and peaceful integration in the world economy?

Will the United States show leadership—at home and internationally—in reviving its core economic strength while simultaneously leveraging those capabilities through an activist economic diplomacy?

[This] is not the occasion to present a full agenda for the United States.

Yet this is the place to suggest that the American experience in actively connecting economics and security needs to be revived.

In his classic study, *The World in Depression, 1929-39*, Charles Kindleberger argued that it was critical for one major power to take the lead in shaping an international economic system. This power could not dictate, but instead needed to invest in encouraging a shared approach to trade, capital flows, currencies, and reliance on markets. Kindleberger described how during the Great Depression the United States had the means but not the will to lead, while Britain had the will but no longer the means. If the United States does not lead now, who will?

I do not believe a slow growth economy can lead. Bob Carr's warning about America's need to resolve its budget mess is correct: The United States must restore its credit for its own health and to enable it to lead.

The United States does not need just any budget deal. It needs one that rebuilds the fundamentals of long-term growth.

The full text of Mr. Zoellick's speech is available online at http://www.iiss.org/conferences/alastair-buchan/alastair-buchan-lecture-2012 (26 September 2012).

Robert Zoellick was President of the World Bank from 2007 to 2012.

# The Challenge for Germany: How to Reconcile Its Traditional Pro-European Role with Rising National Temptations

German leadership is now at the forefront of the discussion on the future of Europe. Torn between its traditional post-World War II position as reluctant power and the need to show more assertive leadership, Germany is playing a key role in navigating a path through the crisis. Germany is the biggest creditor nation, and as such asked to provide the main bulk of the financial backstops needed to contain the crisis. The country is the biggest stake-holder in the euro. And yet, many Germans have never fully embraced the common currency as their own.

## The Historical Context: The Importance of Reconciliation and Political Union



The euro was never very popular in Germany. In the 1990s, when a group of European nations led by Germany and France decided to give up their national currencies, a solid majority of Germans opposed the idea. Over the previous forty-plus years, the Deutschmark had become a powerful symbol of German wealth and stability, a reality that had vanquished the specter of inflation.

However, then-chancellor Helmut Kohl decided to go ahead with the project despite popular opposition. It was both a political and an economic decision. Political, because it cemented the European project and German ties with its traditional foe, France. Economic, because since the collapse of the Bretton Woods system and the end of the dollar peg in the early 1970s, Germany had lobbied hard for a new exchange rate system that would reduce the exposure of its export-driven industries to currency fluctuations. Not surprisingly, the German establishment, both political and economic, was and still is deeply vested in the project of the common currency.

Speaking in July 2012, Pascal Lamy, Jacques Delors' chef de cabinet and later EU Commissioner for Trade, argued for a broader perspective on the economic and financial crisis: "The discipline we have forgotten to bring in on supranational governance issues is anthropology."[3] While anthropology can identify the deep practices, norms, cultures, and values that have driven the European idea and help explain the collective action as well as national differences, the related discipline of history is equally essential. As Germany and the European Union choose between a **Decisive Europe** and a **Diffident Europe** at home and abroad, it behooves us to remember both the dark history of pre-1945 and the alternative history of European integration during the last six decades. Sixty years is sufficient time to establish patterns of behavior. Context and challenge have surely changed over the decades, but political habits endure, especially for Germany.

The founding value of the European Community was reconciliation as a political and moral antidote to a history of war, as articulated by both Robert Schuman and Jean Monnet. It was built around the Franco-German tandem, but radiated out to the whole structure of the Community. Germany's European and international reputation was restored as a result of its reconciliatory practices in its bilateral relations with France and in its multilateral dealings, rendering it a regional and global leader. Reconciliation with Israel made Germany the Jewish state's chief advocate within the EC/EU. And, reconciliation with Poland and the Czech Republic was one of the key drivers of Germany's staunch support of those two countries' admission to the EU. Reconciliation, however, has never meant harmony. Germany's interactions with France, Poland, and the Czech Republic in the EU have been characterized by both cooperation and contention, but the habit of reconciliation has meant the willingness to confront serious differences and to seek compromise, whether on budgetary or constitutional issues.

Angela Merkel's May 2008 statement (when the economic and financial crisis was well underway) on the virtue of reconciliation is part of a long German thread, stretching back to Adenauer's pragmatic and moral goals for German rehabilitation via the European project: "We can anticipate the future only when we keep remembrance alive. Only with that recognition can we appreciate the miracle of the gift of reconciliation between our peoples and of the peace system of European unification. While this gift is costly, equally large is the danger that we can give in to a feeling of self-satisfaction."[4] Reconciliation and peace, she recognized, require constant self-reflection and self-criticism.

Germany's commitment to political union from the time of the Schuman Plan on was the fraternal twin of reconciliation, aiming to proffer the institutional infrastructure for peace. Germany always conceived of political union as two-dimensional: the internal dimension, to achieve, where possible, greater supra-nationalism (without eradicating completely national preferences and priorities); and the external dimension, to serve as both a magnet (in terms of either membership or highly structured relations short of admission) and a model (in terms of an exemplar for regional conflict resolution).

3 Pascal Lamy, "Setting up and governing the euro," Notre Europe Tribune, 10 July 2012, http://www.notre-europe.eu/uploads/tx_publication/SettingUp_GoverningEuro_P.Lamy_July2012.pdf (21 September 2012).

4 Bundeskanzlerin, "Rede von Bundeskanzlerin Merkel anlässlich der Verleihung des Internationalen Karlspreises," 1 May 2008, http://archiv.bundesregierung.de/Content/DE/Archiv16/Rede/2008/05/2008-05-01-karlspreis.html?nn=273438 (21 September 2012).

The twin conceptions—internal and external—are clear if one looks at the many plans for greater political union of which Germany was the author or co-author (often with the French) just in the 1980s and 1990s alone: the 1981 Genscher Initiative and Genscher-Colombo Initiative; the 1983 Stuttgart Solemn Declaration; Kohl's 1985 proposals at Milan; positions at the intergovernmental conference leading to the 1986 signature of the Single European Act; the Maastricht Treaty; the Essen European Council; and the 1996 Intergovernmental Conference. For the new millennium, Germany demonstrated its commitment to political union during the country's 2007 EU presidency, with Angela Merkel's resuscitation of the constitutional deliberations that paved the way for the Lisbon Treaty.

As Merkel insists on political union today as the price for fiscal and banking union, she does so for pragmatic reasons related to guaranteeing and protecting Germany's interests, but also because of her fundamental belief in the European idea. The leitmotif of her foreign policy in the last seven years has been: "Interest-based foreign policy must also be values-driven foreign policy," just as the word "reconciliation" has two dimensions in the German language: *Versöhnung* (spiritual, emotional) and *Aussöhnung* (practical, political).

Germany has achieved deeply embedded reconciliation with its former enemies on the European continent; both the German political class and public opinion have internalized the values of peace it has wrought. But both of these players, who have noisily questioned the European idea in their reluctance to show greater solidarity with laggard members of the community, can still be mobilized, at least as evidenced in the snapshot of public opinion polls. Eurobarometer 77 (undertaken in May 2012) revealed that almost half of German respondents mentioned peace when asked: "What does the EU mean to you personally?" The EU-27 figure stood at 25 percent.[5] Germans can also be mobilized around their pocket books, and now may be the time to retool the cost-benefit analyses involved in the "Cost of Non-Europe," first applied to the losses associated with not having a Single Market in 1992, and more recently to the relative absence of a common defense and security policy.

Progress on political union has always been difficult from the very inception of the European Community, with the failure of the European Defense Community in 1954 and the related European Political Community. Yet, it has moved forward, even if with slowness and non-linearity. Success has come from the trifecta of vision, leadership, and compromise, and often in moments of crisis. Like reconciliation, European integration needs crisis to a uthenticate its ideals and to show resilience, as Monnet understood: "People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them."

5 Available online at: http://ec.europa.eu/public_opinion/archives/eb/eb77/eb77_first_en.pdf (21 September 2012).

Germany still has more to lose from a collapse of the euro, both politically and economically, than any other country in the euro zone. About 60 percent of German exports go to countries in the European Union. The share of exports going to the more limited number of member countries of the euro zone is about 40 percent. Despite the rising significance of emerging markets, only about 18 percent of German exports are headed to the so-called BRIC countries. These are all underlying facts that should never be forgotten when trying to make sense of short-term turbulence.

## Germany's Commitment to the Euro Zone

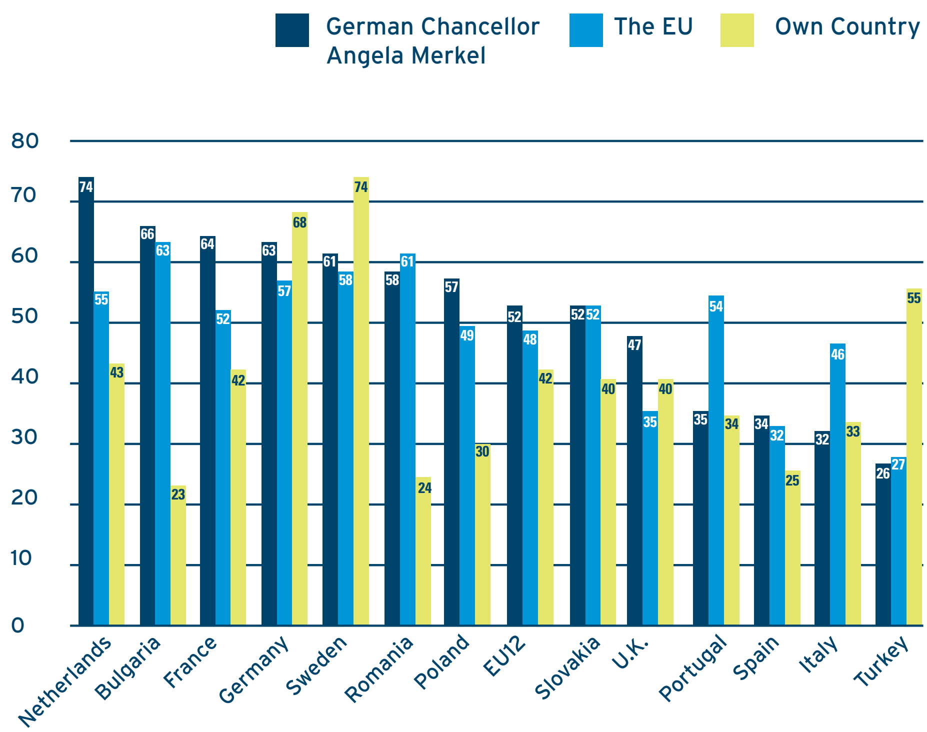
In a cover story last summer, *The Economist* highlighted popular skepticism about Germany's underlying commitment to the euro zone. It published a fictional memorandum to German Chancellor Angela Merkel, outlining two possible scenarios for a partial euro break-up, one with Greece leaving the euro zone, the other with all current recipients of aid, including Spain, reintroducing national currencies. The headline read: "Tempted, Angela?"

It would appear that Angela is not tempted—but Germans increasingly are. Therein lies the main domestic challenge for the German chancellor and the main danger for the euro. As the views of citizens increasingly diverge from those of their governments, the crisis has moved well beyond the mere question of who should pay the final bill. We are not only witnessing a confrontation between reluctant creditor and struggling debtor nations. Europe is grappling with the democratic deficits of its current institutional architecture.

Not surprisingly, in an attempt to tame diverging forces, a cautious Merkel has chosen to provide only limited financial solidarity to struggling euro zone partners, and she has provided this support only if those countries receiving it carry out a series of painful adjustments. Until recently, she has even allowed members of her own governing coalition to openly debate whether the euro can or should be preserved in its present form. Merkel is a pro-European politician, but her actions have given priority to national responsibilities over those of the EU as a whole. Member states must do their homework, she believes, before a closer Union can be successfully achieved. German solidarity, albeit limited, will be forthcoming when member states have clearly shown their commitment. The paradox of this cautious step-by-step approach that paints the picture of a closer Union as only a distant prospect of the future is that Merkel has contributed to a worsening of the public debate around Europe. The gap between short-term necessities and long-term objectives has widened. And of course, the more distant those objectives appear to be, the bigger the German reluctance to provide unlimited, direct help to European partners in the short term.

The consequence of this cautious strategy explains her current success in German polls, but it also explains a growing anti-German and anti-European backlash in debtor countries. At home, Merkel is seen as both principled and pragmatic; in the periphery, she is increasingly seen as a German emperor who rules the distant provinces by diktat. This has created uncertainty, and this uncertainty has infected the markets, pushing a number of European countries to the brink of insolvency. The tenuous bond of trust between markets and the political leadership has been broken. Markets are skeptical that politicians stand ready to do whatever it takes to save the euro. Germany, at least as much as struggling debtor countries, has become a tail risk to the survival of the euro zone.

**Figure 2: Respective Approval Ratings of:**




Source: Transatlantic Trends 2012 (Washington, DC: The German Marshall Fund of the United States, 2012): 21.

If Merkel really wants to put these doubts to rest, she has to find a way to reconcile her rhetoric with her actions. She has to close the gap between her need to be principled and the necessity to act pragmatically. She has to convince markets and Europeans in general that the euro is irreversible, and persuade her fellow Germans that it is in Germany's interest to do whatever it takes to preserve the common currency. Ultimately she has to convince her European partners and her citizens that Germany is ready to give up more national sovereignty for Europe. This is the biggest political challenge she faces.

Unfortunately, the time window for bold steps is closing quickly. In 2013, an election year, Merkel will be tempted to avoid a truly open debate about Europe and the euro in Germany in order to solidify her lead in the polls. She will also try to avoid making hard decisions, such as agreeing to a truly integrated banking union. Now that the ECB has made clear to all skeptics that Europe has its lender of last resort, the German chancellor could be tempted to stick to her step-by-step approach.

## "If the Euro Fails, Europe Fails"

Looking ahead into an uncertain future, Germany's leadership recognizes that it is not strong enough to act alone in a world undergoing a huge transformation. For an economy that relies on its exports, keeping trade channels open is synonymous with preserving the German economy. For a country that geography placed right in the middle of continental Europe, any temptation to act unilaterally died in 1945. It is true that 1989 eliminated the threat of the Soviet Union. However, the fall of the Berlin Wall and German unification did not eliminate the need for a stronger Europe. Berlin still needs Brussels. The EU is not a superpower in traditional terms. It still has no army and no real foreign policy, but when it comes to disputes about trade, or regulating and policing the single market, or even defending western, democratic values, the EU Commission dwarfs the national governments. Berlin has no illusions about this reality and no desire to reverse sixty years of European history.



### Germany's support of the EU is based on a pragmatic view of its position:

- The political leadership in Berlin recognizes that a break-up of the euro could lead to a break-up of the single market and dramatically weaken the German economy.

- A break-up of the single market would jeopardize the whole European project.

- The European project is still seen by the German establishment as the best insurance policy against political instability in the core of Europe. In fact, it is still seen as a model to resolve global challenges. It is a multilateral approach focused on cooperation rather than a unilateral one with inherent dangers of confrontation.

- Europe remains the best vehicle to advance German economic and political interests. A stronger Europe is the only answer to the challenges posed by the global shift in economic and political power.



In reality, these priorities limit Germany's room for maneuver. Almost three years into the crisis, even a partial breakup of the euro, which some German commentators now deem necessary, appears to be only a very remote option. Not surprisingly, despite numerous public comments by members of her government to the contrary, the chancellor even considers an exit of Greece from the euro zone as potentially destabilizing—and therefore undesirable.

# 3 The Struggle to Reshape Europe

## The Challenge of Managing Greece: Choices, Consequences, Conclusions

Greece has been the epicenter for the crisis for almost three years. During that time, the country has triggered turbulence in financial markets and put in question the ability of European leaders to find a way out of the crisis. Most Germans have lost patience with Greece and have reached the conclusion that the country could now finally leave the common currency area without dragging anyone else down with it. Many investors also believe that Greece will have to leave the euro zone. There are three possible scenarios for Greece.

### 1. "Grexit"





Some observers argue that, freed from its currency straightjacket, Greece would quickly regain competiveness. Contagion effects to other peripheral countries could be contained by a massive intervention of both the permanent bailout fund (European Stability Mechanism or ESM) and the ECB. Over time, markets would recognize that Greece was a one-time event. German voters would embrace such a step and probably be more inclined to tolerate unconventional steps to protect the rest of the euro zone.

The paradox is that while the markets and German public opinion have lost faith in Greece's chances of staying in the euro zone, the likelihood of a Greek exit is becoming more remote. In fact, we believe that the negative impact of a Greek exit still outweighs the potential benefits. The costs of a "Grexit" would be substantial, both in political and economic terms. By some estimates, Germany could be stuck with a bill of around €110 billion. Still a manageable amount, some might say. But this amount does not take into account the so-called contagion effects which are impossible to calculate. In the absence of a real banking union with a common deposit insurance scheme guaranteed by member states, a Greek exit would very likely trigger a bank run in other peripheral countries. Yields for the sovereign bonds of Spain and Italy would skyrocket, forcing a massive intervention by the ECB and the ESM in order to stabilize both the already weakened banking system and struggling sovereigns such as Spain and Italy. Even if the ECB succeeded in the short term, the tail risk of a larger euro break-up would cause uncertainty to persist, and continue to have a negative impact on all peripheral economies. France and Germany would be pushed into a recession. Investors and credit agencies, acting pro-cyclically, would focus their attention on the core of Europe. German voters would grow even more impatient with the European project. Merkel's crisis management could come under fire domestically as well as internationally. As a result:

- Merkel's domestic position in an election year could considerably weaken.

- Merkel's willingness to show solidarity at a European level would suffer.

- It is conceivable that Greece's society, faced with a new shock and rampant inflation, would finally implode.

- Germany would be blamed.

## 2. Extending Greece's Lifeline

An alternative scenario would be for Merkel and her European partners to throw Greece yet another lifeline that keeps the country afloat well into 2013. This would allow Spain to get ready to withstand the negative fallout of a Greek exit. Greece's fate would have to be decided later, probably well into the coming year. However, even this strategy would carry considerable risks.

With the Italian and German parliamentary elections inching closer in early and late 2013, respectively, Merkel's room to maneuver will shrink considerably. Italy is too big to bail out and Germany wants to make sure that Rome stays committed to a path of reform. To achieve this goal Merkel needs an ally in Rome and wants to prevent the controversial former Italian Prime Minister Silvio Berlusconi from returning to power. Italy's economic situation needs to stabilize and improve. The technocratic Italian Prime Minister Mario Monti needs to avoid being forced to ask for a bailout for at least two reasons:

- While an intervention by the ECB on financial markets would surely cap yields on Italy's sovereign bonds, it is also clear that such a step would seal Italy's political fate.

- Monti's political capital would be depleted. His ability to influence the selection of his successor would evaporate. Monti has repeatedly declared that he will step down after the elections and hand over power to a government of politicians. Euro-skeptic political forces would increase their chances of success in the Italian polls.

Merkel will have to carefully weigh the pros and cons of a protracted phase of uncertainty surrounding Greece. She will probably look for ways to keep Greece funded at least until after the German election.

# Privately Financed Growth as the Third Pillar of a Program to Save the Euro—and the EU

**Roland Berger, Honarary Chairman, Roland Berger Strategy Consultants**

Europe's sovereign debt and currency crisis is in its third year, and politicians are increasingly limiting their euro bailout efforts to two action packages: "Austerity" for the crisis-ridden countries, and "Financing" for the (still) healthy euro countries in the north, especially Germany. Both are appropriate and necessary, but are not enough to stave off a collapse of the common currency—or perhaps even of the European Union.

In the meantime, this narrow focus on austerity and financial aid has led Europe into a threefold crisis. First, the sovereign debt and euro crisis has become worse. Second, the economies of the euro zone and the EU have been pushed into a recession, led by the debtor countries. Their austerity programs conjure up images of 1920s Germany. And third, European integration is suffering from a serious political crisis. Shrinking economies are making things worse for the countries hit hard by the crisis: unemployment is rising, wealth is evaporating, and social tensions are increasing. Some media in these countries are saying a "diktat from Brussels" has forced them into poverty. The northern countries, although still financially sound, also feel forced into an undesirable position, and understandably so. They do not want to risk their savings to help neighboring countries finance debt they racked up by "not keeping their houses in order." Europe is deeply divided.

Economic growth is necessary to restore Europeans' confidence in their currency and their Union. Yet state-sponsored growth programs are clearly not the way to go. For one thing, they would create further public debt. For another, they would not even solve the growth crisis, since it is not an economic but rather a structural crisis of competitiveness. The only way to solve such a crisis is through structural reforms, including cutting spending, wages, and costs. So what should we do?

The way out of the crisis is a politically supported, but privately funded, growth program that works on a market economy basis. This program would aim to expand and modernize Europe's infrastructure. Necessary investment for such a program is estimated to be at least €1 trillion in the EU. To finance it, we can tap the estimated €170 trillion held privately around the world. It is now up to politicians to help channel private capital into infrastructure projects. They can do this by passing regulations that encourage both competition and investment and putting in place non-ideological and legally sound conditions based on the market economy.

Topping the list of potential projects is the telecommunications infrastructure, which needs broadband data highways to reach the next technological level. These highways are hitting an investment roadblock in the form of European government policy dating back to the days of the postal and telephone monopoly. Private investment in these areas is simply not attractive. This means large telecom service providers, such as France Télécom/Telecom Italia/telefonica, cannot mobilize any private capital. If politicians could bring themselves to pass innovative regulations in line with the market, this could trigger significant growth: Investing more than €270 billion in the communications infrastructure would not only create several hundred thousand jobs in Europe, but would also increase the productivity of users in the private sector and in public administration. Europe could see the development of its own IT and internet industry, similar to Google, Amazon, or Facebook in the U.S.

Another example is power supply. Over the next few years, Europe will need to invest €220 billion in grids and storage—especially after Germany's energy transformation. This will require a European energy policy and the planning certainty such a policy needs. Neither is in place. Moving on to other examples, sewage and waste water treatment systems would need at least €200 billion, and road construction requires an estimated €180 billion.

Unfortunately, the predominant ideology in Europe holds that infrastructure should be kept in government hands as far as possible, with some odd differences from country to country. For example, in France water is provided by private companies, but the government is responsible for electricity. In Germany it is just the opposite: water is the government's job, while electricity is provided largely by private firms. Many countries have privately-financed toll highways, but for some reason that does not seem to be possible in Germany, which is one of Europe's main transit countries. The list of these kinds of inconsistencies goes on and on.

Even a partially privately-financed infrastructure program, designed as a market-based growth plan for Europe, could therefore serve as the missing third pillar of a consistent euro bailout program. The other two are the structural change created by austerity for improved competitiveness and budgetary discipline in the south, and the bridge financing supplied by Germany and the northern euro countries to calm the financial markets.

With these three pillars, Europe could create a highly innovative and productive economy with an excellent infrastructure, even in the midst of the crisis. As suppliers, private companies would profit from the growth and increased productivity; employees would benefit from the rising number of higher quality jobs. Increased tax revenue and lower public spending could help reduce public debt. An additional benefit would be restoring people's confidence in the euro and European integration.

### 3. A Managed Default within the Euro Zone

Greece could be allowed to default on part of its debt after the German elections. Restructuring all its official debt (what Greece owes the official sector, i.e., the euro zone countries), would not necessarily mean an exit from the euro zone if the process is managed carefully. In fact, restructuring the Greek debt once again could become necessary in order to break Greece's vicious cycle of austerity, recession, and more austerity.

**However, there are at least three necessary preconditions before a new haircut on Greek debt is a possibility.**

- Greece needs to decisively implement a series of structural reforms (including a wave of privatizations and opening closed professional sectors).

- These measures should make it easier for Greece to run a substantial primary budget surplus, which is the second condition the country needs to meet. In this scenario, most of Greece's debt stock could be written off. No more bailout funds would flow in the direction of Athens, and the country would have no access to bond markets. Skeptics are quick to point out that this approach carries substantial risks. Freed from its debt burden, Greece could very well resume financing current account deficits through the ECB by issuing debt that Greek banks would buy and place with the ECB as collateral to obtain liquidity (provided that the ECB accepted those securities).[6] Moral hazard remains a legitimate concern.

- In order for a restructuring of Greek debt within the euro zone to work, national governments' hands (and in particular Athens' hands) need to be tied by a significant transfer of fiscal sovereignty to Brussels.

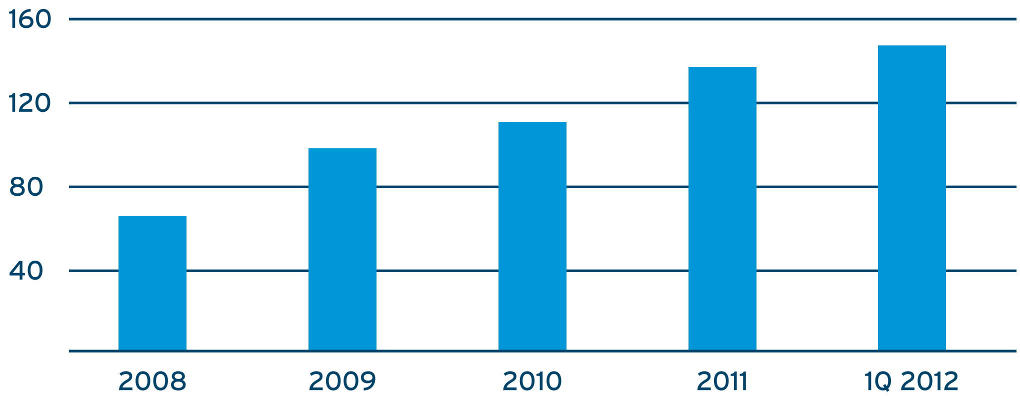
## The Case of Spain and Italy

While it is unquestionable that Greece still has the potential to trigger significant turbulence, the fate of the euro will be decided in Spain and Italy. Both countries are mired in a deep recession and credit conditions have tightened substantially (see the figures on Non-Performing Loans). Spain in particular is suffering from a classic banking crisis. The Spanish and Italian governments might need support from the ECB and the ESM in order to overcome short term refinancing difficulties and in order to break the vicious link between bank troubles and the sovereign debt crisis.

6 Peter Garber, global strategist at Deutsche Bank, discussed this in a number of articles. See: "The Mechanics of Intra Euro Capital Flight," *Deutsche Bank Economic Special Report*, 10 December 2010 and "The Target Mechanism: Will It Propagate or Stifle a Stage Three Crisis," *Carnegie-Rochester Conference Series on Public Policy*, vol. 51 (December 1999): 195-220.

The real price for any rescue of Spain—and possibly Italy—is a partial, albeit temporary, loss of sovereignty. And this explains why both countries have resisted rescue packages with strict conditionality attached. While being subjected to intrusive controls through the so-called Troika does not necessarily mean that they will permanently lose their fiscal sovereignty, the mechanism carries a lasting political stigma.

**Figure 3: Spain - Non-Performing Loans (EUR bn)**

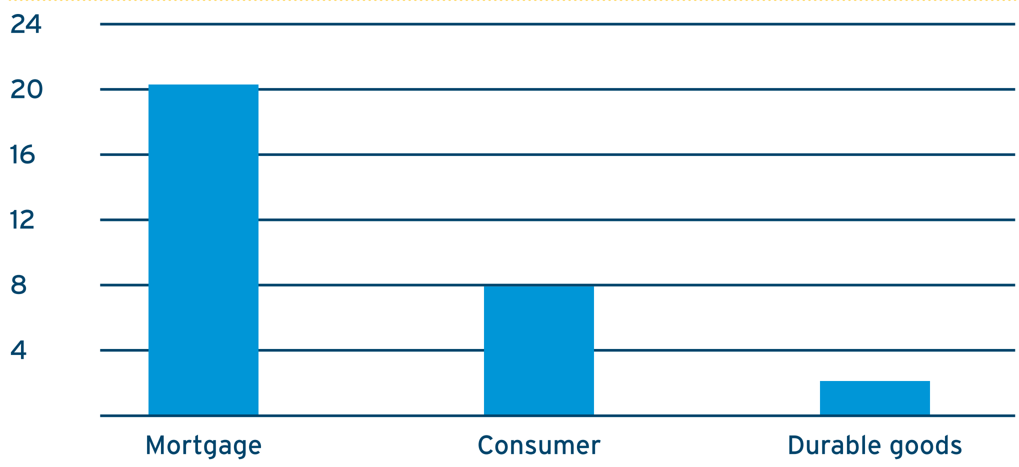



Source: Bank of Spain



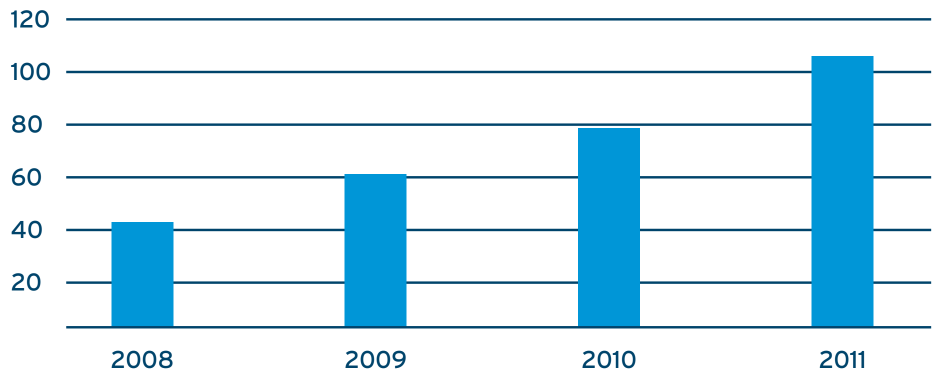


**Figure 4: Spanish Non-Performing Loans - Individuals (EUR bn) as of March 2012**



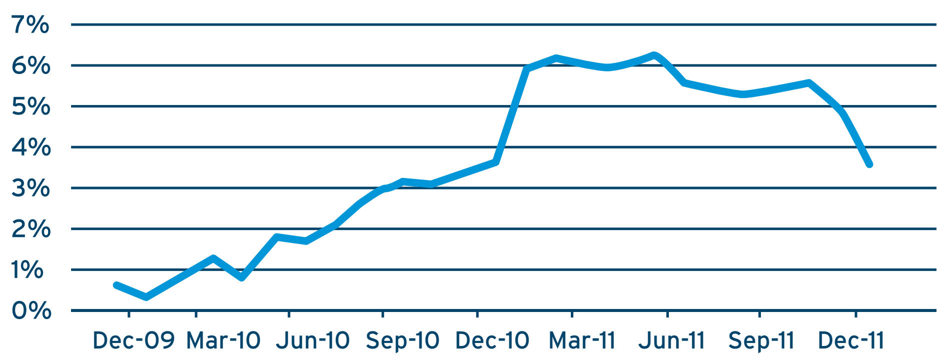

Source: Bank of Spain

**Figure 5: Italy – Non-Performing Loans (EUR bn)**




Source: ABI Italian Banking Association

**Figure 6: Italian Loan Growth Analysis**




Source: ABI monthly outlook



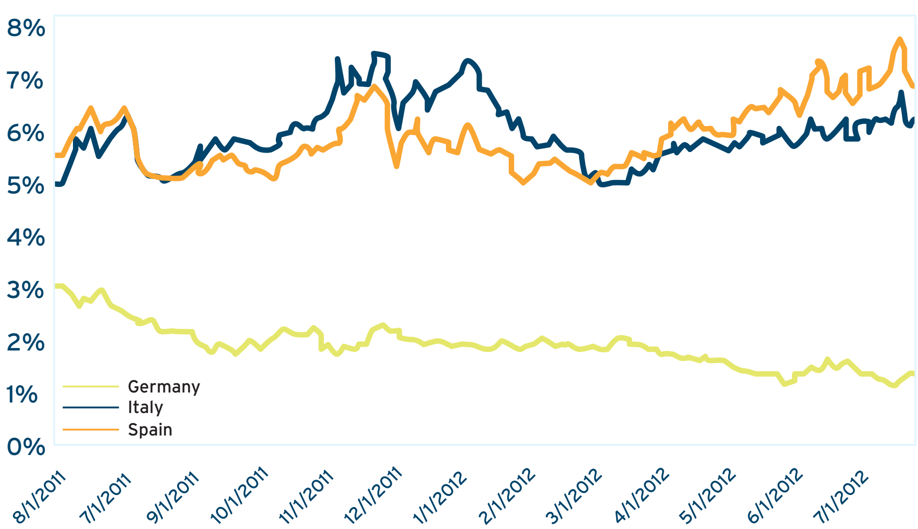
At the time of this writing, Spain has not yet requested a full bailout program from its European partners. A request for aid by Spain would demonstrate that the ECB's new bond-buying program works. The rescue program should prove that even a big euro zone country can successfully slip under the central bank's protective umbrella without causing a new existential crisis within the common currency area. Spain's bailout would clearly represent a precedent and would be the blueprint for further intervention by the ECB. However, the unstated goal is to avoid having to apply such a rescue program to even bigger countries, such as Italy. Italy is still perceived as too big to bail out and the political cost for an intervention by the ECB would be incalculable, particularly in Italy and Germany.

## In the event of a Spanish bailout, it would be designed to achieve three main objectives:

- To stabilize the situation in Spain;
- To act as a sufficient deterrent for both Italy's political class and for financial markets. However, it is unclear whether a program for Spain reduces or increases risks of contagion for Italy. It really depends on how credible Italy's medium-term commitment to reform is. Italian politicians will certainly try to avoid the Spanish fate. Financial markets will watch carefully;
- To enforce yet another temporary transfer of fiscal sovereignty from a country receiving aid to EU institutions, this time under the new joint ECB-ESM supervision.

In fact, it could be argued that Germany is pursuing the goal of a loose common fiscal union, one that is equipped with a powerful deterrent mechanism, in which the real transfer of fiscal sovereignty is both painful and temporary, and in which Germany has a veto power.

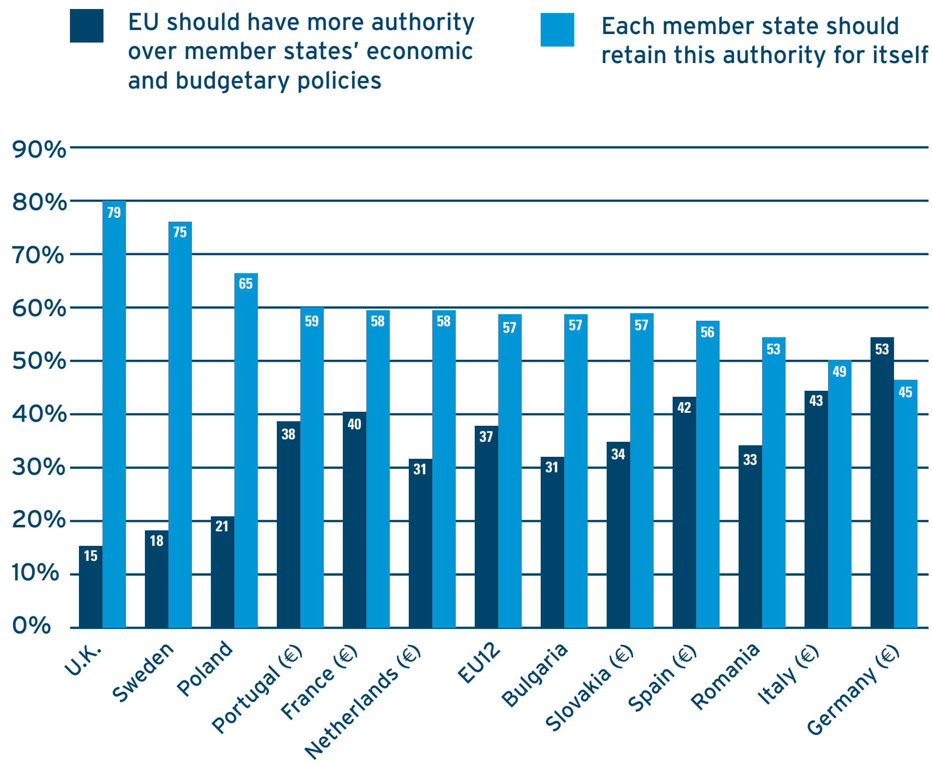
**Figure 7: 10-year government bond yields in Germany, Italy, and Spain**




Source: Datastream

Some of the necessary tools for such a loose fiscal union are already in place, such as the so-called European semester (introduced in 2010 and under which member states agree to coordinate *ex ante* their budgetary and economic policies), the so-called six-pack (which has strengthened European fiscal and macroeconomic surveillance on member states), the fiscal

**Figure 8: Approval of More EU Economic Oversight of National Finances**




Source: Transatlantic Trends 2012
(Washington, DC: The German Marshall Fund of the United States, 2012): page 22.



compact (which primarily focuses on budget and overall debt limits), and the intrusive presence of the Troika in countries undergoing so-called full macroeconomic adjustment programs through the European Financial Stability Facility (EFSF) bailout funds and the ESM. These measures merely represent first tentative steps toward a closer fiscal union. However, if binding these elements together in order to brand them as a fiscal union is Germany's real political goal, no one should expect any more significant steps toward closer European political integration anytime soon.

The German government has resisted any significant transfers of fiscal sovereignty from Berlin to Brussels, citing the rulings of the German Constitutional Court (which in the past has given Merkel a very narrow space to maneuver) and the unwillingness of key partners to move in the direction of closer fiscal and political integration (France in particular. See Figure 8). Not surprisingly, the most significant and visible steps undertaken toward a broadly defined goal of a fiscal union have occurred at the intergovernmental level, stressing the role of the European Council over that of other European political institutions. Unfortunately, closer coordination between governments does not mean more integration. Not surprisingly, the debt crisis has placed an excessive burden on the European Council and exposed its institutional shortcomings as an effective crisis-fighting institution acting on behalf of the whole euro area. Because of its composition (made up of heads of government and state), the Council has had a very hard time striking the right balance between national and European interests. Its delays and often ill-timed decisions have forced the ECB to step into a huge political void. Regrettably, the central bank is the only European institution that has consistently acted on behalf of the whole of the euro area.

## Conclusions on Greece, Spain, and Italy

Greece may not be the epicenter of the crisis anymore, but it can still trigger significant turmoil. We conclude that even small, measurable improvements in Athens will be enough to convince Berlin to keep Greece in the euro.

We believe that Spain should apply for a macroeconomic adjustment program in order to erect a protective shield around itself and around Italy.

We do not expect Italy to apply for a bailout program, at least not until after its parliamentary elections in spring 2013.

# 4

# A More Perfect Euro Zone: Toward a Banking Union

## The Struggle within Germany

Overall, since the eruption of the crisis, Merkel has tried to achieve four broad, main objectives.

1. She wants to avoid going down in history as the woman who destroyed Europe.
2. She wants the euro zone to emerge from the crisis as a stronger entity, more German in character, and, if at all possible, with Greece still on board and on a slow but measurable path to economic and fiscal recovery. What is not at all clear is whether Merkel really favors more fiscal and political integration, or rather prefers closer intergovernmental coordination, with a veto power in Berlin.
3. She wants to win the German elections in the fall of 2013 and stay, with or without her present coalition partners, at the helm of the German government.
4. Merkel has been forced to accommodate two powerful national institutions that have often exacerbated, rather than eased, the international crisis. These are the Federal Constitutional Court, which is seen by Germans as the ultimate custodian of the postwar democratic order, and the German central bank, the Bundesbank, which many see as the guardian of German wealth. Merkel has tried to keep these different players on board, but when interests diverge, it is an impossible feat. Both the Constitutional Court and the Bundesbank have limited her room for maneuver in addressing the crisis pragmatically.

More recently, however, the decision in September by the Court in Karlsruhe on the EU's permanent bailout fund, the ESM, and the announcement by the ECB that it stands ready to buy unlimited quantities of sovereign bonds to push down yields, have weakened the role of the two German institutions and further strengthened the European governments' hands in dealing with the crisis.

The paradox is that, despite all the talk about Germany's predominance, it is our view that while Merkel seems to have won the power struggle with the Bundesbank and the Constitutional Court domestically, her bargaining position in Europe is weakening as a result. For two years Germany has kept everyone guessing and has tried to extract as many concessions as possible from its partners, citing, among other things, the narrow path that the government was put on by the Constitutional Court and the Bundesbank. With those constraints largely gone, saying "no" has become much harder.

Ultimately, because of the potentially huge costs involved in a partial or complete breakup, Merkel has no choice but to do whatever it takes to save the euro. We are thus about to enter a new phase in the struggle to redefine the euro zone.

## Debt, Inflation, and the German Psyche

When Germany negotiated the Maastricht Treaty that led to the introduction of the euro, it wanted the nascent currency to be as solid and stable as the old Deutschmark. The main goal was to keep inflation at bay.

Germans fear inflation more than most things—including recessions. The reasons are rooted in the troubled history of the twentieth century, but the roots go even deeper. For a nation of savers, for whom putting money away is not only economically desirable, but also a moral imperative (the necessary foundation for a righteous life and a successful economy), the silent expropriation and redistribution of wealth brought about by rising prices must be resisted at almost any cost. To help throw light on the struggle within Europe, one that goes well beyond politics and economics, looking at religion, or better, morality allows us to better understand the German point of view. It could be argued that what we are witnessing in Europe is a struggle between a Protestant, largely Lutheran view of the world and a Roman Catholic approach to life. This is, of course, a simplification (given the fact that Greeks are not Catholic and not all Germans are Lutheran), but since the eruption of the euro crisis in 2010, there has been the tendency in some of the creditor countries, namely Germany and northern Europe, to increasingly view the euro through a moralistic, Protestant lens, almost as if it were the Catholic Church of the sixteenth century—powerful, corrupt, and foreign.

Not surprisingly debt, regardless of whether it is private or public, carries a moral stigma. Inflation is seen as almost a diabolic tool deployed to reward debtors and punish creditors. For Germans, the debt crisis represents more than just the consequence of a dramatic economic downturn in the advanced economies; it is mainly the result of moral failure. The head of the Bundesbank, Jens Weidmann, even compared the recent plans of the ECB to buy unlimited quantities of sovereign bonds to a Faustian deal with the devil, mobilizing no other than Johann Wolfgang von Goethe to support his opposition to the central bank's decision. The question of moral hazard remains the main reason that politicians in Germany who advocate unlimited financial support for peripheral European countries face such tough resistance. And it is also the explanation for German resistance to Eurobonds or any other form of pooled debt.

## The Struggle Within the EU

What we are witnessing in the euro zone goes well beyond the classic bargaining that pits creditor countries against debtor countries. This is a struggle about the redistribution of political power within the European Union, and particularly within the euro zone. To put it bluntly: if more sovereignty needs to flow from member states to European institutions, then Germany is trying to ensure that the "New Europe" that will emerge from this crisis is more German in character. As we have seen, this strategy is mostly but not only driven by the need to reduce the danger of having to bail out debtor countries repeatedly.

It is also the result of a shift in the delicate balance of power within the euro zone. The old equilibrium between France and Germany is out of whack. The crisis has confirmed France's fears of the past twenty years: German unification has finally altered the dynamics within Europe. Having failed with the approach of its former President Nicolas Sarkozy, who sought to restore an old, now weakened, Franco-German engine (during the last presidential election campaign Sarkozy famously tried to rally supporters by saying "The government of Europe, that's me and Angela"), under its the new French President Francois Hollande, France is now looking elsewhere—namely, toward Madrid and Rome—to regain a better bargaining position. In order to make it easier for Europeans to digest a more "German" Europe, Berlin is trying to push back by popularizing its economic views, known as the "German model." The not-so-subtle pitch to its partners is: the current economic pain will allow you to become a bit more like us and you will regain competitiveness and reap economic benefits. France and the Mediterranean countries, on the other hand, are seeking to preserve their own identities and sovereignty, and to some extent, return to the status quo *ante*. Caught in the middle, and with the exception of the ECB, European institutions such as the Commission and the EU Parliament are struggling to make their voices heard.



### The Question of Eurobonds

Since the beginning of the European debt crisis, the German government has tried to shield German taxpayers from any form of shared debt, including Eurobonds. The "NO" to mutualizing debt is the only, and very symbolic, red line Chancellor Merkel is not willing to cross—at least not until the German elections are over in late 2013. What we hear from government officials in Germany and large parts of the German academic community is: "You don't resolve a debt crisis by piling up more debt." Eurobonds are even described as a sweet poison. While these types of statements clearly resonate with German voters, they have made it much harder to adopt a more pragmatic and less absolutist approach to the crisis. Europe is in danger of fragmentation, with the north dominated by creditor nations, and the south by debtor nations.

## Merkel's Main Ally: The Role of the ECB

It is the ECB's new president, Mario Draghi, who has in effect become the bridge between the European Union's north and south. The ECB has emerged as the only European institution capable of dealing with the crisis effectively. Draghi has positioned himself as "Rescuer-in-Chief," and arguably one of the main European strategists. He has articulated long-term goals and mapped out all the necessary steps in between, including the need for a banking union. He has argued strongly for the need for a common narrative, a road map to closer integration that includes clearly defined benchmarks, and has become the closest ally to Merkel and Finance Minister Wolfgang Schäuble.

In September this year, Draghi launched a new bond-buying program that goes well beyond the scope of the ECB's Securities Market Program (SMP). With the new program, Draghi linked potentially unlimited ECB intervention to the activation of the ESM by a member country in need of help. In other words, ECB support comes at a price: a request by a country for a rescue program with strict conditionality attached. Draghi reiterated the need for long-term structural reforms in the euro zone countries, but he stressed that reforms could be jeopardized if the delicate balance between political and market pressure on one side, and short-term relief on the other, is lost.

According to Draghi, sovereign bond markets are currently in a state of "severe malfunction." Draghi argues that acting on the bond market to re-activate the monetary transmission channels is "classic monetary policy" and well within the mandate of the bank. What is the point of keeping interest rates at record lows, Draghi argues, if making loans in the periphery of Europe is significantly more expensive than in the north.[7] The main goal of launching the so-called Outright Monetary Transactions (OMT) is therefore to make sure that interest rates across the euro zone converge. The ECB has decided that it has to stop fragmentation of the euro area before it is too late.

Despite the resistance of the Bundesbank to such a program, the German government sided with Draghi. Of course, conditionality remains an important component of any financial support provided with German help. The ESM involvement ensures that countries receiving help continue to feel some peer pressure even as yields on their sovereign bonds fall. In order to make sure that governments keep their promise to implement structural reforms, Draghi has specified that the efforts of the ECB would be focused on the "shorter part of the yield curve." In other words, the role of the ECB would not be to rescue countries like Spain or Italy, but rather to help them buy a little more time to implement their structural reforms, and to deter investors from betting against the euro.

7 Mario Draghi, "Introductory Statement to the Press Conference, with Q&A," 2 August 2012, http://www.ecb.int/press/pressconf/2012/html/is120802.en.html#qa (28 September 2012). See also his statement given after the Governing Council meeting of the ECB on 6 September 2012.

Draghi is walking a fine line. He has to act with boldness, but he cannot ignore Germany's concerns. His main partner is the political leadership in Berlin. If he can keep Merkel on board, then the attacks coming from the orthodox Bundesbank can be successfully repelled.

The ECB has become a convenient proxy for the German government. And in fact, having witnessed long and largely fruitless debates about Eurobonds and the size of European firewalls, investors have once again turned their attention to the European Central Bank, the euro zone's lender of last resort.

## The Question of a Banking Union: Challenges and Choices

The ECB's narrowly defined mandate is already stretched to the limit. In the future the central bank will be even more powerful if plans for a closer European banking union are realized. At their June 2012 summit, European leaders finally recognized that in order to prevent further fragmentation and to break the negative feedback loop between the sovereigns and their banks, what is needed is a real banking union. They have committed to undertaking the first concrete steps toward this goal by the end of the year 2012. There is growing consensus around the need for a structure that includes a centralized supervision, a resolution authority, and a common deposit insurance scheme, similar to the American Federal Deposit Insurance Corporation (FDIC), implicitly or explicitly backed by the European governments.



ECB President Draghi's declaration of the irreversibility of the euro and his willingness to back this up with potentially unlimited intervention in distressed bond markets has quelled speculation about a euro break-up. At the same time, it has shifted the discussion to the question of the future shape of EMU. There have always been two visions of EMU: a "Germanic" model of a hard currency union with a completely independent central bank, and a "Latin" model of a union where the central bank actively supports governments' economic and fiscal policies. The Germans thought they had tied down the "Germanic" model in legally binding treaties and now find that this was an illusion. Because of their difficulties to meet the requirements for a hard currency union, the Latin Europeans are dragging EMU toward the "Latin" model. Germany is fighting a rear-guard action, but is likely to lose the battle. EMU will become a Latin Monetary Union.

—Thomas Mayer
Senior Fellow, Center of Financial Studies at Goethe Universitat Frankfurt and Senior Advisor, Deutsche Bank

While a banking union would certainly be an important part of a closer integrated euro zone, it is not a substitute for fiscal and political union. In fact, strengthening the ECB does not in itself address what many perceive as the democratic deficit in the EU. Saddling the ECB with more power and responsibility could make the institution even more vulnerable to political attack.

In current plans, the European Commission envisages a supervisory role for the ECB that, over time, would turn national central banks into mere enforcers of the ECB's decisions. It is an ambitious plan, born in part out of the recognition that national authorities have failed at policing their domestic banking systems. However, a quick agreement on a banking union will be hard to achieve, particularly if the objective is a strong union. Some experts warn that a banking union should not be seen as a convenient substitute for political integration. Without political integration the banking union *per se* would not prevent a bank run. The danger of a run on deposits persists as long as markets perceive a tail risk that the euro zone might break up. If this view is correct, then even a common deposit insurance would not be sufficient to prevent significant stress to the banking systems if some countries are still perceived to be at risk of leaving the euro zone.[8]

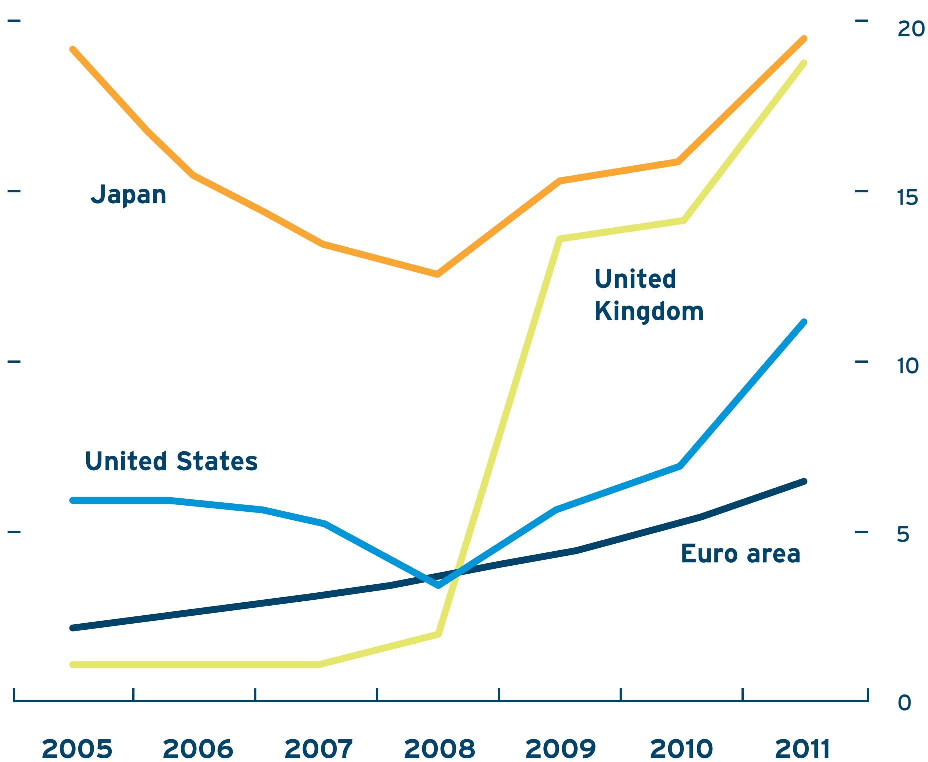
In fact, even within the ECB there is reluctance to assume the position of sole supervisor for the 6,000 European banks. Germany, citing the difficulties of regulating so many institutions through one agency, would like to restrict the role of the new central authority. The government in Berlin thinks that only a very limited number of banks deemed of systemic relevance should be supervised by the ECB. In reality, Germany is trying to shield some of its smaller and politically controlled banks (*Sparkassen* and *Landesbanken*) from closer scrutiny. Not surprisingly, Merkel's government is trying to lower expectations. Reaching a deal by the end of the year is an ambitious goal.

In the worst-case scenario, no agreement is reached within the next few months. Without a banking union, the ESM would not be able to intervene and recapitalize banks directly. Speculative attacks on peripheral countries would probably resume, forcing the ECB to intervene. Every new round of bond purchases has the potential to expose the bank to renewed criticism in Germany. The OMT could lose its power as a deterrent. The bank would be forced to step up its bond purchases dramatically, and perhaps even resort to additional unconventional steps. The government in Berlin might feel compelled to distance itself from the bond-buying program and the ECB.

8 For more information on banking union, see work by Nicolas Véron, Visiting Fellow at the Peterson Institute for International Economics and Senior Fellow at the European-based think tank Bruegel. "Challenges of Europe's Fourfold Union," Prepared statement by Nicolas Veron before the U.S. Senate Committee on Foreign Relations: Subcommittee on European Affairs Hearing on "The Future of the Eurozone: Outlook and Lessons," 1 August 2012, http://www.foreign.senate.gov/imo/media/doc/Veron_Testimony.pdf (28 September 2012) and "What kind of European banking union?" with Jean Pisani-Ferry, André Sapir, and Guntram B. Wolff, 25 June 2012, http://www.bruegel.org/publications/publication-detail/publication/731-what-kind-of-european-banking-union/ (28 September 2012).

If an agreement is reached that does not clearly define the resolution authority and the question of the deposit insurance scheme, the reaction of the markets could be similar to that outlined above. A "banking union-light" will simply not do the trick. At this point in the crisis, symbolic steps have lost their symbolism, and are now perceived as a sign of helplessness rather than serious commitment.

**Figure 9: Trends in Central Bank Gross Claims on Government (Percent of GDP)**




Source: Fiscal Monitor April 2012: Balancing Fiscal Policy Risks (Washington, DC: International Monetary Fund, April 2012): page 17.

## Banking Union

A comprehensive agreement is the only outcome that would have a calming effect on jittery markets. If not all of the necessary elements for a banking union can be implemented effectively at once (and the EU Commission's proposal does not suggest they should), a clear time frame for a very detailed roadmap needs to be part of the deal. The ultimate goal should include a centralized oversight of all the European banks, not only those deemed systemic. Creating a two-tier banking system jeopardizes the creation of a truly integrated banking union.

Because of her own electoral timetable, it would be preferable for Merkel to close a deal in the coming months. If she does not, reaching an agreement will likely become impossible in the German election year 2013.

# 5 Conclusions: A Question of Symmetry

**The banking union has become a test of the level of Germany and Europe's real commitment to closer union. If handled decisively and positively, it would prove that the continent is moving in the direction of a Decisive Europe. Germany would have to give up at least as much sovereignty over its banks as other European countries. An agreement could therefore reintroduce some symmetry in a process that so far has been perceived as imbalanced by both creditor and debtor countries. Public opinion in the core countries in the north, especially in Germany, upholds the belief that they are paying for the sins of profligate southerners. The prevailing perception in debtor countries is that ceding fiscal sovereignty has been a largely asymmetrical process, a one-way street, from the periphery to the core.**

A prolonged and poisoned debate on a banking union has the potential to widen rifts within the euro zone. If Berlin becomes a major stumbling block, this would reinforce the view in the periphery that Germany is pursuing a national agenda at the cost of debtor countries.

A failure to reach an agreement on a banking union could therefore renew market doubts about the European political leadership's ability to undertake real steps toward greater integration. This would once again create significant uncertainty. Uncertainty is poison for fragile economies that are trying to recover from a steep recession. Last but not least, renewed and prolonged uncertainty coupled with a further weakening of the European economy will negatively impact the German economy in an election year and undermine Merkel's own efforts to win a third term.

European politicians must step out of their comfort zone and signal that they are truly committed and able to take significant steps toward the stated goal of closer integration. It is time for the political class to deliver on promises made. Furthermore, they must resist the temptation to rely solely on the ECB for help. While it is certainly comforting to know that the euro zone finally has its lender of last resort, the bank should not be used as the only effective crisis-fighting tool. As Mario Draghi is fond of reminding us, the ECB is but one supporting leg of a strong common currency area. If Europe really wants to walk out of the dark tunnel it entered almost three years ago in one piece, it also needs its second leg: political leadership.

Germany and its European allies still have a fundamental choice to make: do they really want to correct the birth defects of the euro and move toward a closer political union or are they content for national governments to act as firemen and to introduce corrective interventions as needed in times of stress? It is not at all clear if this fundamental choice has been made.

Does Angela Merkel have the resolve to be both visionary and practical? A **Diffident Europe** suggests a hesitant, confused actor internally and externally, stymied by lack of purpose and incomplete institutions. A **Decisive Europe** assumes a more (not complete) federal structure, projecting greater institutional rationalization and efficiency, resulting in a more purposeful and efficacious international presence. Recent developments (the German Constitutional Court's September 12 decision to allow the ESM to become operative) suggest that Germany may be inching in the direction of a **Decisive Europe.** It is now up to politicians to come together and move toward that goal. A failure to do so will weaken Europe for the foreseeable future.

# About the Authors

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Alexander Privitera is a Senior Fellow and the Director of the Business and Economics Program at AICGS. He focuses primarily on Germany's European policies and their impact on relations between the United States and Europe. Previously, Mr. Privitera was the Washington-based correspondent for the leading German news channel, N24. As a journalist, over the past two decades he has been posted to Berlin, Bonn, Brussels, and Rome. Mr. Privitera was born in Rome, Italy, and holds a degree in Political Science (International Relations and Economics) from La Sapienza University in Rome.

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## Dr. Jackson Janes

Jackson Janes is the President of the American Institute for Contemporary German Studies at Johns Hopkins University in Washington, DC, where he has been affiliated since 1989.

Dr. Janes has been engaged in German-American affairs in numerous capacities over many years. He has studied and taught in German universities in Freiburg, Giessen, and Tübingen. He was the Director of the German-American Institute in Tübingen (1977-1980) and then directed the European office of The German Marshall Fund of the United States in Bonn (1980-1985). Before joining AICGS, he served as Director of Program Development at the University Center for International Studies at the University of Pittsburgh (1986-1988). He was also Chair of the German Speaking Areas in Europe Program at the Foreign Service Institute in Washington, DC, from 1999-2000.

Dr. Janes is a member of the Council on Foreign Relations, the International Institute for Strategic Studies, and the Atlantic Council of the United States. He serves on the advisory boards of the Berlin office of the American Jewish Committee, the Allied Museum in Berlin, the World Security Network, Beirat der Zeitschrift für Außen- und Sicherheitspolitik (ZfAS), the Robert Bosch Foundation Alumni Association, and the American Bundestag Intern Network (ABIN) in Washington, DC. He is also President of the International Association for the Study of German Politics.

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