

## A VOTE THAT WILL CHANGE EUROPE

The Brookings Institution, September 23, 2013

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The German federal elections on September 22 gave a resounding victory to Angela Merkel who is now German Chancellor for the third time in a row. Merkel's party, the Christian Democratic Union (CDU), saw results that were significantly better than expected. Merkel herself defined the outcome as historic. The swings in the electorate should not have come as a surprise. The vote was emotionally and politically loaded as it was driven by worries related to the safeguarding of the financial stability of German households in the midst of the European crisis. Merkel emerged as the leading force -- forging the future of Europe -- and as a defender of national interests.

The most important result of the vote was the failure of the euro-sceptic party *Alternative fuer Deutschland* (Alternative for Germany) to enter the Bundestag. *Alternative* would have changed the face of the German centre-right 90 years after the fragmented and extremist political landscape of the Weimar Republic. It would also have broken the taboo of German post-war democracy: no radical party to the right of the CDU. *Alternative* intended to use its Parliamentary role as a platform for systematically calling on the Constitutional Court to block Merkel's pro-European policies. This blockage would have killed off all decisions taken by Merkel and her European colleagues in Brussels. However, in falling just a few votes short, the tectonic shift triggered by *Alternative* has not occurred.

If the vote was influenced by the European events, its outcome will also influence them. Merkel's centrality not only in Germany but in Europe now looms unchallenged. Such a degree of control of European politics in Merkel's hands is prompting analysts to suggest that not much will change in the German stance on European integration and the future of the euro-crisis. In fact, one should probably see Mrs. Merkel's philosophy as "do not change anything, so that everything will have to change."

The no-change view is based on the fact that in Germany, all decisions on the EU are made by consensus between Merkel's CDU and the left-leaning Social Democratic Party (SPD), Germany's most popular party after the CDU. In particular, since the beginning of 2013, the SPD, Green Party and *Der Linke* ('The Left,' a party that is to the left of the SPD) command an absolute majority in the Bundesrat, the Upper House that must agree on all federal legislation relating to administrative costs or taxation issues. No change of majority at the Bundesrat is possible before 2015 even if CDU wins all the upcoming elections. The balance of powers that forms between parties with different ideologies dictates the search for pragmatism and for the kind of gradual procedure that has characterized the last years. In the short term, after her remarkable success, Frau Merkel should feel freer to take a proactive role in negotiations with the European partners. A coalition with the Social Democrats is widely viewed as more predisposed to support a more growth-oriented agenda. A more favorable environment could allow the ECB to take unconventional policy actions that it had been reluctant to embrace out of concern that this could unsettle the German electorate.

However, if this is the short view, in the long term Chancellor Merkel seems aware that a lot of political and economic tensions have been building under the European turf over the last five years. She knows that these troubles must be addressed through a political project. According to the initial signals, Merkel intends to turn European governance upside down. As we shall see at the end of this paper, the kind of project that Merkel has in mind can only be understood by observing the effects of the euro-crisis on German politics and vice-versa.

## HOW THE EURO IMPACTED GERMAN POLITICS

One way to verify the impact of the crisis on German political preferences is to analyze, over the period of the crisis, the trends of the electoral consensus for three parties: the Christian Democratic Union, the Social Democratic Party and the classically liberal Free Democratic Party (FDP). The chart below focuses on the period when the financial crisis became one of the main themes in the German public discourse, and heavily impacted public opinion on the various parties.

Since early 2009, the global crisis has been discussed largely as a crisis of a financial nature. The responsibility for the crisis, it was argued, lies with the greedy bankers of Wall Street and their speculative hubris. In September 2008, as a consequence of German bankers' misconduct, the entire German financial system was about to collapse. It was a period when bankers were spoken of as 'banksters.'

The reaction of German public opinion was very vigorous. In recent memory, it is hard to find such sudden changes in public opinion. There are two exceptions: the CDU scandal at the end of the nineties, and the crisis into which Gerhard Schroeder's government fell after the introduction of the major structural reforms between 2003 and 2006.

Between Fall 2009 and Fall 2010, the FDP, which was seen as close to the banks, lost two thirds of its electorate. Its popularity fell from fifteen to five percent. Peer Steinbrück, then the German Finance Minister, led a strong SPD campaign against "Anglo-Saxon" finance. This narrative earned his party an increase of 10 percentage points which allowed it, for the first time in years, to be within a whisker of equaling CDU's popularity.

Things changed suddenly again in May 2010. When the Greek crisis broke and called on Europe for a bail-out, the crisis changed its nature and physiognomy. Since that point, the situation was no longer seen as a global financial crisis, but as a crisis in those euro-area states that had been unable to keep their public finances in order. Since then, the CDU has been recovering in the polls.

A further implication of the changing nature of the crisis became rapidly clear: the crisis of some countries required that other European countries - first of all Germany - provide financial aid to those financially weaker nations. Defending national interests, of which the CDU became the standard bearer, became a major political concern. In fact, whenever the crisis became more serious (July 2011, November 2011, July 2012) Chancellor Merkel's party reaped substantial benefits in the polls. Since the outbreak of the Greek crisis, the advantage of the CDU over the SPD increased from 3 to 18 percentage points.

In addition to influencing the German domestic political balance, the new narrative of the European crisis as a Greek tragedy or as a problem of peripheral countries also profoundly changed the diagnosis and therapy of the European crisis itself:

1. Before May 2010, the crisis was a financial crisis affecting the European economic and social model that had been strained and perverted by reckless financial speculation. Such a crisis would have required a change in the economic model. Consequently the crisis would have needed to be tackled through a common European response.
2. After May 2010, the crisis became a fiscal crisis in which some countries that had lacked financial discipline found themselves in a quagmire. Such a crisis needed to be resolved primarily by those countries. This kind of approach inherently

distinguished along national borders between good countries and bad countries, virtuous or profligate. The “fiscal” crisis accentuated the national distinctions and required distinct policy answers in each country.

The first narrative of the crisis as a financial one would lead to a European political union (a new shared social model), while the second narrative, that of a fiscal crisis, leads instead to a marked political division between the states of the euro-area. Hence, the real consequence of the Greek problem was that it represented the watershed between a federal destiny for Europe and something very different that we need to imagine.

In order to understand why the euro crisis has so polarized the German electorate, we have to study the polls very carefully. From this analysis a picture emerges of three different Germanys with three different thematic references: a "social" Germany concerned with issues of fairness and justice, a "cultural" Germany (concerned with family, environment and national interests) and an “economic” Germany. A synthesis of the preferences of the Germans is something like a “Christian-liberal” economy in a society and culture that have social democratic and green values.

In this context, the political advantage of the CDU over the SPD is justified by the prevalence of three elements of strength, all closely related to the current crisis: the fate of the euro as the primary issue of concern for voters, the deeper economic competence credited to the CDU more than to the SPD, and finally the convergence of the former points in the personality of Super-Merkel, the dominant leader in Europe.

How could it happen that the culture of solidarity of the German society was so clearly crushed by the alleged “Euro-selfishness” and by the economic calculation of the short term benefit?

For the SPD, once it rejected populist shortcuts, the issue of the euro has become a ditch with no way out. Month after month, Chancellor Merkel has adopted a presidential style that received wide acclaim abroad. She has regularly avoided partisan political overtones as part of her European strategy. The fact that the negotiations have been carried out among the heads of government has much reduced the margins for criticism by the Federal Parliament and thus also by an SPD that wanted to remain constructive and ensure an appropriate status for its ambition to govern in the future. In the meantime, Merkel has made the image of her European line coincide perfectly with the image that the Germans have of her as a concrete personality, never vain, reliable, intelligent and hard-working. The Chancellor avoided engaging in tiresome alternatives, of which she even denies the existence, and this enables her to act as a pivot for reconciliation policies within the country and ultimately as the representative of the interests of all German voters. Finally, she accentuated her image as a central political figure with a strategy of "subtraction" of the themes dear to the SPD and the Greens, embedding them in a campaign platform that looks as ecumenical as possible.

In the end, what the Greens and Social Democrats consider the Chancellor’s “Euro-selfishness”, became politically unassailable. Both Merkel and Steinbrück know that the vast majority of voters hold three dangerous simplifications of the crisis: Merkel is holding together our currency; we Germans have already shown enough solidarity with other countries; it is only fair that if we have to give our money to someone else, we have the right to say to those countries what they should do with it.

Questioning Mrs. Merkel's Euro-selfishness would require the rewriting of the crisis from its origins (as Steinbrück tried to do in the last phases of his campaign), returning responsibility to the banks rather than to single countries. As previously mentioned, the political difference is huge, because in the first case the solution requires a change in the European socio-economic model and needs to be

found by all countries together, while in the second case the solution of the crisis needs to distinguish between good and bad countries with Germany in the role of the virtuous country teaching others the right way.

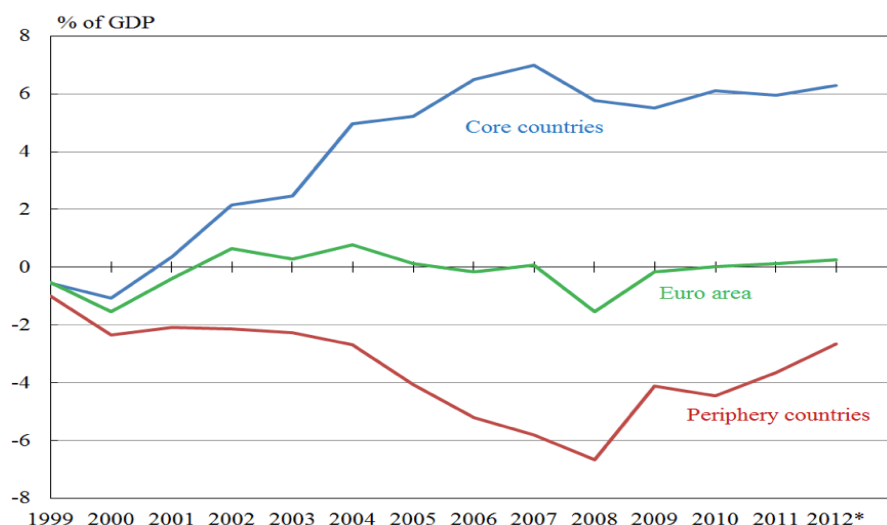
For the SPD to emphasize the failure of Merkel's strategy – denouncing the impoverishment of the neighboring countries - was as awkward as reciting the famous verses of Paul Celan: "Death is a German master." Hardly a good slogan to win elections in Germany. Criticizing Merkel's strategy was not easy for other political reasons. Germany is the only country where the crisis has had no effects on income distribution among the voters. The theme of social justice, the workhorse of the SPD, is therefore useless. The crisis has also brought Germany tangible financial benefits, as well as a political prestige that Germany has lacked since the days of Otto von Bismarck. Finally, the crisis did not affect employment at all, it in fact increased, depriving the SPD of yet another of its traditional platforms.

Chancellor Merkel has obviously and consistently used the narrative of the crisis as a crisis of public finance. In the *Regierungserklärung von Bundeskanzlerin Dr. Angela Merkel zu Stabilitätsunion, Fiskalvertrag und Europäischer Stabilitätsmechanismus, 29. Juni*<sup>1</sup> she says: "The causes of the crisis are due to the irresponsible fiscal policy by some Member States responsible for violation of the agreed rules."

What remained untold was that *even if* the cause was not fiscal, the remedies - monetary transfers - certainly were fiscal in nature. The priority was to ensure rigor in public finance. Consequently, the treatment of the crisis was a two-pronged strategy: budgetary discipline and "self-responsibility" in all member countries. The primary law reference is Article 126 of the EU Treaty, which regulates procedure to avoid excessive government deficits, as well as the no-bailout clause. The Fiskalpakt and the ESM Treaty – that represent the legal framework of the new governance designed to address the crisis - arise from an interpretation of the crisis itself as primarily a fiscal one.

Although the crisis did not originate from fiscal problems *tout court*, there is a proximity between oversized fiscal requirements and the need to attract savings at a time of financial turmoil. So the world's attention turned toward an explanation of the euro-crisis as a crisis of the balances of payments in the "periphery" nations, highlighting a general deficit of savings that could be either public or private.

### *Divergence of the Balance of Payments*

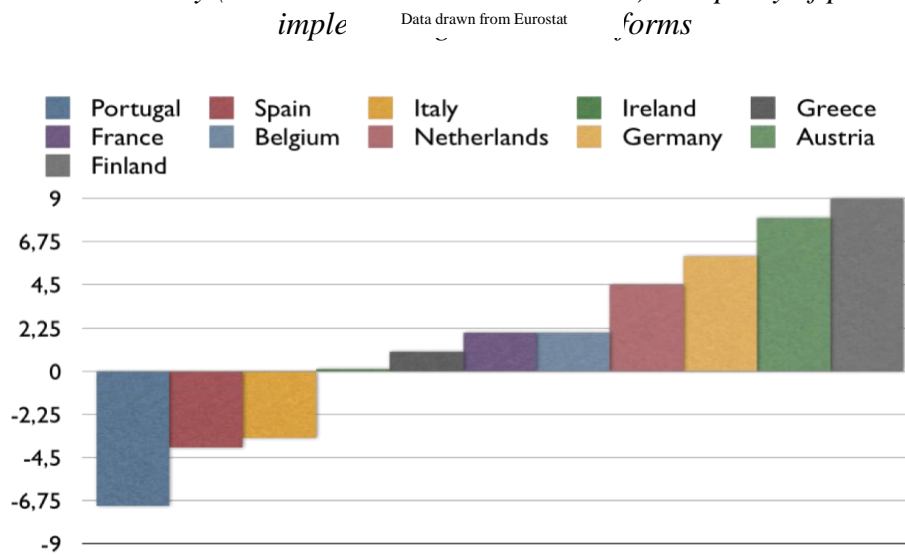


<sup>1</sup> 2012 siehe Plenarprotokoll 17/188 vom 29. Juni 2012

The deficit in public savings refers directly to the explanation of the fiscal crisis. The deficit of private savings refers instead to the lack of competitiveness in some economies (reflecting in the current account deficit of the balance of payments). But in European rhetoric, competitiveness as well as fiscal policy depend on the ability of politics to create the premises for a competitive economy.

As a matter of fact, if one takes the change in productivity as a consequence of reforms by the governments aimed at increasing competitiveness in the economy, one easily finds that those countries that are weaker are also those that are less able to implement reforms.

*Total Factor Productivity (variation between '98 and 2008) as a proxy of political capacity in*



Inevitably those countries that are less competitive also become countries that are less "capable" politically. We just need a short step to reach an inference full of deep implications:

The countries that are least able to make structural reforms are also the countries whose societies are less advanced in terms of institutional quality. The indicator of "institutional change" represented in the graph is based on evaluations of the criteria of transparency, honesty, respect for the rule of law and so on. These ratings are very arbitrary. In addition, after excluding the outliers, the correlation between quality and institutional reforms for competitiveness disappears (it suffices to consider the BRICS to demonstrate that these correlations are only relatively meaningful). However, this Weberian interpretation is now common sense.

At this point, the conclusion is ve Data drawn from Conference Board and The World Bank tries in trouble are the same countries in which politics and democracy are of lesser quality. Lower capacity means lower value. So it is a matter of moral inferiority or political dysfunctionality.

Hence the setting underlying the therapy of the euro-crisis as represented by Merkel's CDU. It is characterized by a number of political criteria aimed at containing the sovereignty of the countries that are in need of political assistance.

The first criteria in Merkel's template is "conditionality and compliance." It requires that all aid is conditioned to the fulfillment of programs of adjustment and reform designed, imposed and controlled by an external authority (the Troika: EU-ECB-IMF) and aimed at giving the country financial strength and competitiveness. A second criteria is the "Ultima Ratio": in order not to violate the no-bailout clause and not to lead to a Transfer-Union, aid may be granted only when the whole Euro area is in danger. In order to stress further the responsibility of each country, it is also necessary to avoid "Moral Hazard" by limiting the quantity of financial assistance so that the recipient country is not deprived of its own responsibility in correcting its imbalances. This protracted the crisis for years instead of solving it. However, in Merkel's view, a common warranty for the debt of the states is ruled out by German Fundamental Law and by European Treaties.

Following the same principle of self-responsibility, private creditors must take the consequences of the risks of their investments as the "Bail-in" criteria foresees addressing the crisis of the financial institutions. These ideological orientations are more rooted in the liberal party (FDP). However, Merkel has adopted these principles and she believes they can be applied on a European scale. Having adopted the role of instructor to the other countries, Merkel wants to be in control of all the key decisions on the financial funds (EFSF and ESM) that indeed must be taken unanimously or by a qualified majority that is likely to be blocked by Berlin. Inevitably those decisions are taken according to a principle of "asymmetric sovereignty" and the principle of inter-governmentalism becomes the cornerstone of European negotiations as opposed to any of the old attempts to build a federal Europe.

The principles just described were clearly reflected in the electoral program of the CDU. Merkel promised the German electorate she would maintain the current course with the other countries: the *Doppelstrategie* of fiscal deficits reduction and structural reforms. She repeatedly evoked the popular formula of "aid only against achievements." Countries under assistance need to help reduce their public debt and implement reforms and investments for the future in education, training and technology. The future use of EU funds for development, cohesion and solidarity need to be aimed at increasing competitiveness and increasing employment among European youth. The strategy is intended to stress a very popular commitment to preserve a strong and stable German currency (the euro). The CDU program writes that, in order to defend the stable currency, Europeans need more deficit reduction, as well as strict adherence to limits on public debt. The objective is to achieve balanced budgets everywhere. There is no misunderstanding in what it means for the CDU: no Debt-union and no Transfer-union. While SPD and Greens wanted a mutualization of debts through the introduction of eurobonds, CDU thinks this would be a path to a union of debts where the German taxpayer would carry almost unlimited liability for the debts of other countries' taxpayers.

The principles embraced by Merkel give a clear view of what she has in mind or the next steps on the way to the solution of the euro crisis as designed in the road maps written by the major European institutions (EU Council, EU Commission, Eurogroup and ECB). On a banking union, CDU favors a common supervision by the ECB for the Euro-area bigger banks and a mechanism for banking resolution. For other banks, including Sparkasse and Genossenschaftsbanken, supervision should remain as it now is. CDU is against a common deposit insurance policy and does not want the German saver to pay for other countries' depositors. As far as a fiscal union is concerned, Merkel's view is very limited: the rules of the Stability Pact must be strictly observed and the monitoring policy should be strengthened. CDU also wants a procedure for the restructuring of public debt for countries that are no longer able to sustain them. Finally, on the economic union, Germans want to contribute to improve the competitiveness of the whole of Europe. Merkel intends to launch the initiative of a common decision on how to increase competitiveness. Later, possibly in December of this year, she wants to launch a "Pact for Competitiveness" by reason of which the individual states engage with the European Commission to implement concrete reforms.

## CONCLUSIONS

The Euro and the economic developments of the euro-area are of vital importance for Germany. There is a two-pronged influence stemming from the euro-area that directly affects the German level of activity. On the one hand, a classic demand effect comes from the euro-partners and, on the other hand, an “uncertainty-effect,” determined by political instability in the euro-area, impacts business expectations in Germany. A recent report by the IMF (IMF: Germany’s art. IV July 27, 2013) discovered an unexpectedly high effect on domestic investment coming from both these factors. The sizable downward revision of growth estimates in Germany in 2011-2013 is largely attributable to the economic and political instability of the euro-area. So even on the basis of the evaluation of national interests, Germany will remain committed to preserving the integrity of the euro-area.

The strategy on the way to a banking and a fiscal union is clearly aimed at avoiding financial costs for the German taxpayer. This may prove delusional. The premise for a banking union will be the process of asset quality review that may become a stumbling block for the economy of the euro-area. Strict criteria of asset valuation are already inducing a process of deleveraging particularly across the banks of the periphery. The consequences for the economy in the next twelve months might be sizable. The effect is severely aggravated by the regulation for banking resolution as published by the EU Commission. Apparently, the need to achieve a primary capital ratio of 4.5% will have to be satisfied - almost entirely - affecting the creditors of the bank. Once investors – or even depositors – become aware of the risk implicit in most banks, the consequences may slip easily out of control. Direct recapitalization by the ESM or other funds may become unavoidable implying costs for the creditor countries. Fiscal positions of the States are dependent on how the banking situation evolves, but banks' predicaments will inevitably impact the economy and the stability of fiscal budgets. So the issue of mutualization of guaranties or debts is likely to emerge again in the next 12-24 months and could be picked up by Merkel’s ally in the Grand Coalition that is likely to emerge after the vote. This will induce a reflection on the structure of the euro-area and on the future of Europe.

It is important to understand that Merkel has in mind a radical change in the philosophy of European integration, breaking free from Helmut Kohl’s legacy. In Merkel’s view, no comprehensive solution can be implemented at once. The process will remain gradual. If the domestic negotiations for the formation of the new government proceed rapidly enough, in October 2013 Merkel will try to launch a discussion at the EU Council level on the ways to produce economic growth in Europe. She intends to avoid the introduction of the golden rule (allowing for more investment expenditures within the limits of common budget rules) and focus instead on classic supply side structural reforms. It should be called “Pact of Competitiveness.” Once an agreement is found, it should represent a template for bilateral treaties between each single country and the EU on binding reform processes. The Treaties may be supported by financial assistance (maybe 60 billion) provided through the EU Solidarity or cohesion funds or even the EU Budget aimed at financing the reforms in those countries that struggle to keep the German pace.

The bilateral Treaties will become the backbone of a new institutional arrangement for the future of Europe. Merkel wants to downsize the role of the EU Commission reducing the number of competences and functions attributed to the supranational body by the EU Treaties. She maintains that French President Francois Hollande and herself will be on the same page and will discuss together a wide range of issues – labor policies, pensions and fiscal or social policies – using competitiveness as a compass. The cornerstone of the new institutional architecture will remain the heads of governments. Merkel clearly opposes a strengthening of the EU Commission and any

effort toward the emancipation of the Commission from the EU Council. Although a proposal to that effect was recently approved in a CDU parliamentary committee, she resists the idea that the next president of the EU Commission might be elected directly by the citizens. Such an eventuality would upset the institutional balance of the triangle (Parliament, Commission, Council) of the EU. Merkel would prefer the EU Council to nominate the EU Commission president, or at least have a strong voice on it. The President would then be tasked with the coordination of national policies and interacting with the Council.

The source of democratic legitimation of this institutional setting would lie with the individual countries. Merkel is reportedly not interested in the nitty gritty of European institutional debate and thinks that any strengthening of the role of the European Parliament could be postponed by 10-15 years. More important in her eyes (and her primary policy target) remains the question of how to grow out of the current crisis. She considers the economic awakening of Europe her personal task for her third mandate as Chancellor of Germany.

To Merkel, it is clear that the Commission does not have the strength – and in some way the legitimation – to force single countries to embrace a painful course of reforms. This will become a task for the newly strengthened Council of the heads of government. She even wants to shift the core of the decisions toward the European Stability Mechanism, the financial fund that can play the role of a European Monetary Fund. Currently the ESM is guided by a German and has relatively little duties in terms of transparency and political accountability. Inevitably, Merkel's proposal of a new Treaty that would strengthen the role of the EU heads of states along the lines described above, while trimming the competences of the EU Commission, would be ground-breaking or even shocking.

The explicit repatriation of competences from Brussels to the nation states is aimed at drawing back power to Europe, the UK and other Northern countries. An enhanced role of the nations should go down well with French rhetoric too. However, this vision – in which each country stands on its feet - is grounded in the hope that no major incident happens in the euro-area. Unfortunately, this is an unwarranted premise. Bank predicaments, economic weakness and political instability will resurface after the German elections. Tackling those challenges will require common commitments by both creditor and debtor countries. The idea that the latter will be deprived of their political voice is not credible. The issue of a political union in Europe - of common decisional procedures among the different peoples and states - will remain to be embraced.