Macron's Visions *Confront* Merkel's Reality

BY KLAUS C. ENGELEN

The recent German election results may be more disruptive than Trump and Brexit put together.

The recent cover of *The Economist* reads "Europe's new order," and shows a youthful French president in the glaring spotlight—and a German Chancellor Angela Merkel behind him in the dark shadow. Inside, the article titles tell the story: "A dynamic Emmanuel Macron and a diminished Angela Merkel promise a new balance in Europe," "President Emmanuel Macron's reform plans represent a turning point for his country," "A weakened Angela Merkel enters the last chapter of her chancellorship," and "One plodding, one striding, the leaders of Germany and France will change the EU."

Emmanuel Macron, a 39-year-old financier and former economic minister, was elected President of France in May 2017 with 66.1 percent of the vote over far-right challenger Marine Le Pen's 33.9 percent. He has been celebrated as "Europe's savior" at a time when the European Union is shaken by Brexit, the challenge of President Trump and his "America first" rhetoric, and the right-wing populists on the European continent increasing their political clout.

By contrast, after twelve years as chancellor—eight of them governing with the pro-Europe, center-left Social Democrats as partners—Merkel won a fourth term but is severely weakened, especially with respect to support for the ambitious European reform agenda proposed by Macron and called for by Jean-Claude Juncker, the EU president.

On the evening of German national elections in September 2017, Merkel experienced what the tabloid *Bild* called a "nightmare victory." As the "welcome chancellor" who kept open German borders for more

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German Chancellor **Angela Merkel and** French President **Emmanuel Macron** at the G20 summit in Hamburg in July.

"Europe's Savior"

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than a million refugees, many of them without any identity papers, she paid a heavy political price on the ballot box.

Her party alliance of the Christian Democrats and the Christian Social Union, its Bavarian sister party, received 33 percent of the national vote count, down from 41.5 percent four years ago. Merkel's coalition partner, the SPD, dropped from 25.7 percent in 2013 to 20.5 percent, its worst postwar result. Taken together, Merkel's party alliance of CDU/CSU lost sixty-five seats and the SPD lost forty seats.

So it did not come as a surprise that Martin Schulz, the SPD challenger for chancellor, who was a great speaker as president of the European Parliament but never got his act together running against Merkel in the election campaign, announced he would lead the SPD into opposition only minutes after the voting results were announced. Schulz wants to rebuild the party base but he cannot be sure how long Germany's oldest party will allow him to stay on as chairman.

For many it came as a shock that the anti-immigrant, anti-euro, far-right Alternative für Deutschland got 12.6 percent of the vote, thus becoming the third-strongest political force in the new Bundestag. AfD emerged, followed by the market-oriented liberal Free Democrat Party with 10.7 percent, Linke with 9.2 percent, and the Greens with 8.9 percent, in the new more-fragmented 709-seat parliament as the third-strongest political grouping.

For Europe, some argue, the German election results may be worse than Trump and Brexit put together. As the vote for Merkel's coalition collapsed, the big winners are the AfD and the FDP, the two most Euroskeptic parties.

Among the parties in a possible new "grand coalition" under Merkel, the FDP campaigned on a strong Euroskeptic platform. They were kicked out of the Bundestag four years ago because they fell under the 5 percent limit. One reason was that they were deeply split on the neverending rescue packages for Greece which they considered were not in line with the EU treaties. But under the highly skilled leadership of their young chairman Christian Lindner, the FDP liberals returned to the Bundestag with a vengeance, gaining eighty seats.

During his long campaign, Lindner made an election pledge to his voters that, "With the FDP, a money pipeline out of Germany into other EU states will not happen." He also promised voters that the FDP stands for a Europe that respects the EU treaties under which each member state has to meet its national responsibility.

So far, German Chancellor Merkel has reacted cautiously to the high-flying visions of the new French president.

Entering the German parliament for the first time, the far-right AfD, which had pursued a strong anti-immigration and anti-Europe agenda, will be the third-strongest party with 94 seats. On election eve its co-founder, Alexander Gauland, a former CDU veteran, called for "hunting Mrs. Merkel in order to get Germany back to its people."

AMBITIOUS REFORM VISIONS

Two days after the German election shock, at the Sorbonne University in Paris, French President Macron set out his visionary reform agenda for Europe. He called for nothing less than a historic reconstruction of Europe and the eurozone, putting most proposals ever made together. He included the creation of a eurozone finance minister who should get a large separate budget. And he supports building the European Stability Mechanism with its €500 billion funding into a European Monetary Fund.

And shortly before that, on September 13, 2017, in his State of the Union speech, EU President Jean-Claude Juncker called for an even more ambitious reform agenda. According to Juncker, all EU member states should adopt the euro as their currency as soon as possible and should receive supplemental financial support in exchange for the completion of the monetary union. This would mean more transfers from financially stronger countries such as Germany, who also have to fill the huge financial gaps caused by Brexit.

Such a proposal is contrary to the stance taken by the German and French governments, who do not want to risk another experience like that of Greece, where a country joined the euro much too early without meeting the needed economic criteria. *Frankfurter Allgemeine* rejected Juncker's reform demands as "more euro, more Brussels, more money," and *Die Welt* called Juncker's plans "absurd," asking on which star the EU spaceship and its captain Juncker have spent the last few years.

It was interesting to observe that so far, German Chancellor Merkel has reacted cautiously to the high-flying visions of the new French president but ignored more or less Juncker's State of the Union agenda under which most of the reform projects would come under the control of an ever-more-powerful EU Commission.

WOLFGANG SCHÄUBLE'S TRANSITION

To make room for Merkel's difficult negotiations on a "Jamaica" coalition of the CDU/CSU, the FDP, and the Greens—named after the colors of the Caribbean nation's flag—Wolfgang Schäuble had to give up the finance ministry. This way, Merkel would be able to include the most powerful ministry in the coalition bargaining. Schäuble, who has been a member of the Bundestag since 1972, will become speaker of the German parliament. In this new position—the second-highest in the Federal Republic—he can use his authority and sarcasm to keep the large contingent of far-right new members of the Bundestag in check.

Schäuble's departure leaves a huge gap on the European stage in the view of those who pushed for observing deficit rules and structural adjustments in the decade-long efforts to cope with Europe's financial crisis. Others, like those in Greece and the Club Med debtor countries, are relieved to see him go. Representing the largest creditor nation in the European Union and in the eurozone, he put austerity imprints on most rescue operations, especially in the case of Greece (that Schäuble wanted to kick out of the eurozone, at least temporarily).

When it came to establishing new institutional arrangements like the European Stability Mechanism, Schäuble insisted on using an intergovernmental legal basis where the Eurogroup finance ministers—who would be legitimized by democratically elected national parliaments—could stay in control, not the EU Commission under Community Laws. He also will be missed in the field of global economic and financial cooperation, and in organizations such as the G20 or the G7, where he was seen as a defender of open global trade and the financial regulations that were introduced in response to the financial crisis.

The euro area recovery is fragile.

When Schäuble gave up Germany's G20 chair of finance ministers at the recent IMF/World Bank meetings in Washington, IMF Managing Director Christine Lagarde praised him as "a rock, a giant" in world finance.

LEAVING A "NON-PAPER" AS LEGACY

Before stepping down, a "non-paper" under the heading "Paving the way towards a Stability Union," emanating from the Schäuble ministry, spelled out the reasons why Germany will continue to hold back support for sweeping reforms of the euro area's fiscal management but instead will push for tougher policing of existing rules.

Brussels watchers reacted to Schäuble's legacy paper as a "radical" and "toxic" agenda for "no bailouts, no transfers, automatic debt restructuring, and more bail-ins." To keep the EU-27 together and improve the governance of the European Monetary Union, Schäuble's position paper said, three core principles are indispensable: (1) We must keep fiscal responsibilities and control together, to avoid moral hazard; (2) We need better instruments to foster the implementation of structural reforms; and (3) We need credible stabilization functions to deal with global or domestic shocks.

The non-paper continues, saying since fiscal responsibility and fiscal control belong together, whatever it takes, this only could be implemented if part of national sovereignty and fiscal control is transferred to the EU level—such as installing a "Euro Finance Minister." This would, however, require EU treaty changes in order to be credible.

Since there is little willingness for EU treaty changes, a pragmatic two-step approach would be an intergovernmental solution now, to be transposed into EU treaties later on.

Schäuble says the European Stability Mechanism has proved its worth since it was established in 2012 and "has a well-developed crisis-management system with a set of instruments and financial capacity at its disposal." To become a "European Monetary Fund," the ESM would have to devote more resources to better crisis prevention such as by monitoring country risk as is done in IMF Article IV consultations.

New mandates for the ESM, according to Schäuble, should include monitoring compliance with the EU Member States' obligations under the Fiscal Compact that was adopted in 2012. The ESM also could be given a larger role to monitor the Stability and Growth Pact; both would have to be amended. Also, a new ESM mandate should include a predictable debt restructuring mechanism to ensure fair burden-sharing between the ESM and private creditors. This way, private investors would get better risk-related information that the ESM could provide. In addition, the new ESM should take on responsibility for the future debt-restructuring process and its coordination.

The legal constraints under which the new debt-restructuring mechanism operates are very tough: Incorporated into the legal text of a new ESM treaty on a nongovernmental basis, Schäuble says, should be (a) the automatic extension of the maturities of sovereign bonds in the event that an ESM program is granted; (b) the obligation to carry out comprehensive debt restructuring if this is necessary to ensure debt sustainability; and (c) for the purpose of preventing holdouts, an amendment of the collective action clauses that were introduced, moving to "single limb aggregation" (a requirement for only one vote on the debt restructuring of all the bonds involved without additional votes on the individual bond series).

Before a new ESM could play a "backstop role" in financing of bank resolution as part of the banking union, further significant risk reduction is necessary, including the regulatory treatment of sovereign bonds, says Schäuble.

The paper's final red lines: More ambitious scenarios and plans for the ESM and its financial capacities, either regarding the possible role as an additional backstop for the controversial European Deposit Insurance Scheme, or regarding a brand new fiscal capacity as a transfer mechanism for the eurozone, "would put much too great strain on the ESM and go against its core purpose of bailing-out countries in severe trouble."

Also, Schäuble points out that "debt mutualization would create wrong incentives, raises fundamental legal issues and would therefore put the stability of the whole Euro area at risk. …[T]here is no demand in the market [for eurobonds]. We must be able to create real stability through reforms, not through complex and expensive financial engineering.

THE NEW GERMAN BUNDESTAG IS DIFFERENT

When the financial crisis began a decade ago and escalated into a full-blown euro sovereign debt crisis with Greece, Germany's coalition governments under Merkel could count on broad-based support in the Bundestag from the other parties. In the newly elected legislature, the Social Democrats who used to rubber stamp all rescue packages and institutional reforms on the European stage are now sitting on opposition benches. From there they might act differently.

Since the FDP liberals, in order to return to the Bundestag, campaigned on a strong Euroskeptical agenda, they will come under pressure not to disappoint their voters. The right-wing, anti-immigration, and anti-euro

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Keeping the Far Right in Check

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Wolfgang Schäuble
wields his sarcasm.

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AfD will use the Bundestag as a platform to attack any new commitments that a new coalition under Merkel would make to the EU-27 or the eurozone. That is not surprising, since the AfD entered the political scene as an anti-euro party demanding a return to the EU treaties.

One also has to take into account that in Merkel's CDU/CSU party alliance, there is fierce opposition to such proposals as installing a European finance minister who would control extra budget funds that would be raised through new taxes.

While strongly backed by the German banking industry, there is also strong opposition to the European Deposit Insurance Scheme that the EU Commission launched in November 2015 for deposits in the euro area. EDIS is the third pillar of the banking union. When the EU Commission proposed a compromise aimed at ending two years of deadlock over the plans for EDIS, the Berlin government quickly rejected Brussels' move to revive the plans that have strong support from Paris and other southern capitals. Berlin's finance ministry took the position that Germany would not engage in talks on the EDIS until there was "substantial risk reduction" by European banks.

How assertively the FDP leader, Christian Linder, entered into the coalition talks became apparent in an interview with the leading daily *Frankfurter Allgemeine.* In the battle for the finance ministry, he raised the "structural issue" of who should get the ministry that has played such an important role also on the European stage: not the CDU. "A green, a CSU or an FDP finance minister—anything would be better than keeping the chancellery and the finance ministry in the hands of the CDU," warned Lindner. In the last eight years, according to Lindner, Schäuble's finance ministry served only as a "work bench" to execute the orders from Merkel's chancellery.

Lindner also reminded Merkel that she now runs a "caretaker government" and that she is not authorized to conduct more negotiations. This would also be the case for her chief of staff of the Federal Chancellery, Peter Altmaier, who steps in as interim finance minister when Schäuble takes up his new position as the Bundestag's speaker. Behind the battle for the finance ministry is the power struggle about how a future coalition under Merkel responds to the long and urgent EU-27 and euro area reform agenda.

All this brings us to some conclusions. Recently, in a piece signed by fifteen leading French and German economists, Nicolas Véron of Bruegel presented a road map to a more sustainable euro. The economist argued that Germany will need to accept some form of risk sharing and France will need to allow more market discipline, but the two countries can find a common vision for reforms.

Berlin's decision makers probably will put on the brakes when it comes to ambitious reforms of the eurozone and the European Union.

They warn that the euro area recovery is fragile for three reasons. First, euro area stabilization has relied too much on the European Central Bank. Second, the financial stability of the euro area remains threatened by the legacies of the global and euro area crisis. And third, the euro area's instruments for promoting sound policies at the level of each member country remain blunt and are often ineffective—in particular in averting public debt accumulation. They end on a hopeful note: "Fortunately, the French and German governments have recognized the imperative for reform."

Is this really the case? Under a new Merkel coalition government, Berlin's decision makers probably will put on the brakes when it comes to ambitious reforms of the eurozone and the European Union. Some predict that the German election outcome will halt major reform efforts for the eurozone. After running the German finance ministry since 2009, Wolfgang Schäuble departs, but his legacy of putting the brakes on more fiscal integration and debt mutualization in the euro area will live on. Part of his legacy has also been to take away powers from the European Commission under Jean-Claude Juncker and work closely together with new French President Macron to expand the nongovernmental institutional basis for strengthening the EU-27 and the eurozone governance. For Schäuble and his entourage, the European Commission under Juncker has dismally failed to enforce the Stability and Growth Pact that was promised to the German people as a guarantee against being forced into huge transfers and debt mutualization in the European Monetary Union. Allowing the Italian government, in the case of Banca Monte dei Paschi di Siena, to ignore the recently approved rules against bail-outs, the EU Commission put the completion of the banking union in danger. "It will be very difficult to agree in Germany on a European deposit guaranty fund after the rules were broken in such a blatant precedent," warns Sven Giegold, member of the European Parliament for the Green Party. ◆