WHY GERMANY FELL OUT OF LOVE WITH EUROPE

by
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BRUEGEL ESSAY AND LECTURE SERIES

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FOREWORD

The more the crisis in the euro area develops, the more the last ten years seem to have been an artificial paradise. In that gravity-free world all countries were equal, markets were benevolent and the governments' leeway was only limited by virtual boundaries.

The Greek debt crisis brought this fiction abruptly to an end, restoring gravity and with it the very hierarchy that Economic and Monetary Union was supposed to abolish. In this real world Germany is at the centre and what matters is how far any given country is from it in the eyes of the bond market. The asymmetry of the 1980s and 1990s is back once again.

This has profound consequences for the whole of Europe but especially for Germany itself. In Angela Merkel, the European Union has a *de-facto* leader but one who was not prepared for leadership. Germany is not ready to trade money for power or to enter into any of the usual *quid-pro-quos* that leadership implies. For Germany, the change comes at the very moment when it aspired to behave as a normal country, extricate itself from the obsessive travails of European integration, and turn to the wider global economy where its producers enjoy such success.

This crucial moment when the tension between Germany's true position and its aspirations broke out into the open will no doubt be a matter for scholarly research for many years to come. But today is the time for immediate history, and this is what Wolfgang Proissl offers in this essay, which draws on his experience as a journalist, most recently as the Brussels correspondent of the *Financial Times Deutschland*, and on numerous recent interviews with key players. This enables him to explore why Germany has fallen out of love with Europe, to document how its partners have reacted, and to discuss what the likely consequences are.

Economists and journalists do not approach reality in the same way. We at Bruegel are unreconstructed economists, but we also know the limits of our own methods. This is why we find it enlightening to engage in dialogues with colleagues from other disciplines, and this is in part what the *Essays and Lectures Series* is made for. This is also why we enjoyed having Wolfgang as a Visiting Fellow at Bruegel while he conducted the research and the interviews behind this essay.

I am sure that Wolfgang Proissl's analysis will lead to lively discussions. This is exactly what Europe needs today, because the worst attitude in this situation would be to ignore reality and the major challenges it presents to policymakers, politicians, and citizens.

Jean Pisani-Ferry, Director, Bruegel
Brussels, July 2010

INTRODUCTION: FROM KOHL TO MERKEL

The crises surrounding Greece and the euro have put the spotlight back on the central importance of Germany to the European Union and to Economic and Monetary Union (EMU). No Greek rescue without German participation was credible for the markets. Chancellor Angela Merkel was in a position to shape the solution according to her terms, timetable and domestic political constraints and considerations. But the rescue of a euro-area country did not immediately find its way onto her agenda. It was fifteen months from February 2009[1], when former German Finance Minister Peer Steinbrück first mentioned a possible rescue, to the weekend of 7-9 May 2010, when Merkel agreed to concrete measures to rescue Greece and put in place a safety net for the euro.

A central German role in the EU's economic and financial affairs is by itself no novelty. The deutschmark was the anchor currency for the European Monetary System (EMS). The mark's dominance forced other European countries to fall in line with German economic policy and monetary decisions. The resulting tensions led to momentum to construct EMU. German reunification reinforced the political will of German Chancellor Helmut Kohl and French President François Mitterrand that Germany should be irreversibly bound into European structures.

Since the introduction of the single currency in 1999, euro-area states have taken monetary policy decisions jointly in a federal institution, the European Central Bank (ECB). Markets have viewed the euro area as a single area. They abandoned risk assessments of the sovereign debt of individual euro-area countries and the placing of risk premiums on national government bonds. But German dominance remained a fact of EMU, though it was less visible, diluted in the single currency and the ECB, and was thus acceptable to the other euro-area countries.

This worked because Germany at the time of the creation of the euro area was prepared to act as Europe's benevolent hegemon. German acceptance of the dissolution of the mark in the currency union and the design of EMU according to the German model were crucial. This enabled the euro and the ECB to adopt from the first day the credibility and reputation of one of the world's most stable currencies and of one of its most highly regarded institutions, the Bundesbank.

Germany at that time had an interest in acting as it did. EMU helped to ensure acceptance of reunification despite fears in France and elsewhere. In addition, the euro was supported by Germany's export-oriented industry. German companies, which sold most of their goods within the European Community as was, welcomed the elimination of exchange-rate risk. There was massive opposition from the German public to giving up the mark, the symbol of Germany's post-war success. But there was also a feeling that as a consequence of its Nazi past Germany owed an historic debt to Europe. So Kohl was able to deliver on his promise to create EMU. "The Germans accept strong leadership," he said[2].

Twenty years later, as the euro faced its first existential challenge, Chancellor Angela Merkel was in a very different situation. Most of today's political class was born in the 1950s or 1960s. Many of them are indifferent towards European integration, some express scepticism or even hostility in private. For today's political class, working through the EU is just one policy option among several, and no longer a goal in itself. There is one exception: finance minister Wolfgang Schäuble is a convinced integrationist in the Kohl tradition.

Germany's economic interests are also changing. The euro area is still the most important market for its exports. But the currency area's relative significance for Germany has decreased because of ever-more dynamic business ties with the largest fast-growing emerging economies. As a consequence, German corporate interest in the euro area is declining.

On top of this, the market's perception of the euro area has changed radically since the financial crisis hit Europe in late summer 2008. Investors realised that the competitiveness and the public finances of the euro-area economies diverged significantly, as did the risks of their governments' debts. Risk premiums reappeared and low rates on German bonds once again became the EMU benchmark. Germany, once again, is seen from the outside as the euro area's undisputed leader on all economic and financial policy questions.

Against that backdrop I examine in this essay how Germany has handled the euro crisis. I consider if Germany is prepared once again to be the benevolent hegemon in order to rehabilitate and save the euro from disintegration. Behind this is a broader, more significant question. Historically, Germany was always too big to be just one of many European countries. But it was not big or strong enough to dominate Europe in the long run. EU integration and EMU seemed to have resolved this dilemma and created a stable equilibrium. But the new situation now puts that equilibrium in question.

Being a newspaper correspondent I take a journalistic perspective. I draw on fifteen years of reporting from Paris, Berlin and Brussels on European affairs and on the setting up of EMU, its functioning and the present crisis. I conducted for this essay more than 30 interviews between February and June 2010 – most off-the-record – with decision makers from EU institutions and European governments.

The public focus was on Germany's behaviour during the Greek crisis in the first half of 2010. But Germany's attitude can only be understood if one takes into account developments since reunification. There has been a series of developments. I will explain how Merkel was put into the position of being the EU's *de-facto* leader at the worst possible moment from her domestic point of view. I will show how the lack of understanding in many euro-area countries for the German-inspired rules-based approach to EMU governance, and the Franco-German quarrels about economic governance, undermined support for the euro. I will show how Germany's constitutional court in Karlsruhe dramatically reduced the government's room for manoeuvre in Europe.

The overall picture is of a country falling out of love with Europe. That process started with reunification, which made the country less affluent and more inclined to affirm its national interests in the EU. Then EMU laid the popular basis for euro-scepticism. Abandoning the deutschmark in favour of the euro was never accepted by many Germans. In recent years, the two governments of Chancellor Merkel stopped making the case for the country's engagement in Europe because it was felt that the EU was viewed negatively by voters and the less talk about Brussels the better. The Greek crisis and its culminating weekend of 7-9 May were seen as the end of the model of EMU that the Germans had agreed to participate in. The result was an unprecedented rejection in Germany of the Greek rescue package, the euro stabilisation fund and the ECB's decision to buy government bonds of troubled euro-area members.

EUROPE'S UNWILLING PRESIDENT

There is no shortage of official top representatives of the European Union and the euro area. José Manuel Barroso presides over the European Commission. Herman Van Rompuy chairs meetings of the 27 heads of state and government. Jean-Claude Trichet heads the European Central Bank (ECB) and Jean-Claude Juncker oversees meetings of the euro area's finance ministers. But as the euro crisis unfolded, governments worldwide, policy analysts and markets increasingly ignored those whose job it is to speak for the community and the currency zone. They focussed on one country and its leader: Germany and Angela Merkel. As one top diplomat with direct access to the chancellor observed, "Merkel is the *de-facto* president of the EU and the euro area".

As if to underline this point Berlin has become the main destination for international financial diplomacy. At the end of April, ECB President Trichet and the managing director of the International Monetary Fund (IMF), Dominique Strauss-Kahn, pleaded to a highly sceptical Bundestag of the importance of Germany's participation in the euro area's rescue package for Greece. Many observers felt reminded of the joint appearance of US treasury secretary Timothy Geithner and the chairman of the Federal Reserve Ben Bernanke, in the US Congress in late 2008 in order to convince highly sceptical US legislators of the immediate need to support the controversial Troubled Asset Relief Program. Barack Obama repeatedly rang Merkel over the weekend of 7-9 May to make sure she would support the Greek and euro rescue packages. The only euro-area finance minister who Geithner came to see to talk about the European debt crisis was his German counterpart Schäuble. Clearly the other Europeans, the US and international financial institutions saw Germany as the swing state in the decision to stabilise the euro and address the currency zone's debt crisis.

Germany's centre-stage role coincided with the ending of the market's illusions about EMU really being a union. When the single currency was introduced, the spreads on euro-area member government bonds relative to the benchmark German *Bundesanleihen* disappeared virtually overnight. High debt countries such as Italy saw their refinancing costs drop from impressively high levels to low German levels. The same happened when Greece entered the zone in 2001. The result was that markets and governments alike began to ignore the real risks of unsustainable public finances and the urgent need for structural reform in many euro-area countries. "It was like some kind of sleeping pill, some kind of drug," explained Herman Van Rompuy, the president of the European Council. "We were not aware of the underlying problem"[3].

When the crisis hit Europe with full force in summer 2008, investors suddenly realised that competitiveness in the euro area's southern members had dropped dramatically compared to Germany and other northern neighbours – and will continue to do so. The public finances of most of the southern countries had been severely degraded. For the first time since the introduction of the euro, investors started to fear that some of the euro area's countries would default. As a result they returned to asking for a risk premium when buying bonds from the so called PIIGS: Portugal, Ireland, Italy, Greece and Spain. Joaquín Almunia, then EU economic and monetary affairs commissioner, spoke of a "source of great concern" while the Eurozone finance ministers' chairman Juncker talked of an "increasing worry"[4].

It took some time for markets and the euro area's governments to fully realise the deeper implications of this trend. The reappearance of spreads significantly changed the power balance within the currency area. Suddenly Germany became the focus for the markets. Its decisions and behaviour *de facto* dictated to all other governments how to proceed if they wanted to act credibly in the eyes of investors. Merkel's comments became the barometer of the likelihood of a bailout. Whatever Germany did to guarantee fiscal rectitude became the benchmark for what investors expected other countries to do in order to demonstrate credibility. Thus many countries now feel compelled to think about writing strict German-style debt limitations into their constitutions, or implementing severe consolidation packages. Even France, the second largest euro-area economy and until recently not subject to any market doubts, suddenly felt the combined heat of the market's expectations and Germany's *de-facto* leadership. "The first thing I look at every morning is the spread differential between France and Germany," French prime minister François Fillon said[5].

Politically this development is undoing what the creation of the euro and the ECB was supposed to have settled definitively. Prior to the single currency, Germany acted unilaterally and the independent Bundesbank in Frankfurt decided interest rates according to German economic circumstances. The other countries of the so called 'D-Mark-bloc' followed – including France. This regularly created economic and political tensions. Paris in particular found it to be unacceptable, and so blamed the Bundesbank for all of Europe's economic ills. Karl Otto Pöhl, the Bundesbank's president from 1980 to 1991, remembers the "cheap policy to make the Bundesbank the scapegoat for the errors and failings of the others"[6].

"The deutschmark is Germany's atomic force," Mitterrand said in 1988, explaining the political power that the then still-divided Germany derived from its currency[7]. Overcoming France's economic subordination to Germany became one of the most important aims of France's European policy. In 1990 shortly after the fall of the Berlin wall and just before Germany's reunification, Mitterrand explained to British prime minister Margaret Thatcher why France devoted so much effort to getting a European single currency. "Without a common currency, we all of us – you and we – will be subordinate to the German will"[8]. France today fears a reappearance of its systematic economic inferiority to Germany.

Others however are seeking leadership from Berlin. "Our community needs Germany in a leading role. Otherwise we have a problem," Commission President Barroso said[9]. Tommaso Padoa-Schioppa, former Italian board member of the ECB and among the founding fathers of EMU, called for an increased sense of German responsibility for Europe, to show other countries the best way forward in the common interest. "German leadership of Europe is a fact," he said. "Ignoring this would be the wrong way for Berlin to exercise its leadership"[10].

Merkel knows that "Europe today has its eyes set on us; without us, against us there cannot and there will not be a decision," as she told the Bundestag in the debate about giving German assent to the €110 billion Greek rescue package[11]. But Merkel is restrained in her ability to exercise this leadership by different factors. Unlike previous years it no longer pays politically in Germany to be seen as Europe's driver force. The EU no longer has overwhelmingly positive associations for the German public. Another factor is the deeply rooted culture of self restraint in Germany since the second world war. It is almost impossible for Merkel to convince Germany's deeply sceptical political class that the country has become the most important protagonist in the euro area with a hegemonic responsibility. As one prominent member of Merkel's previous government put it: "I don't think we should bring out our conductor's baton"[12].

Merkel knows that she is the only one of the 27 heads of state or government who has an effective veto power in economic matters, according to Klaus Gretschmann, director general and chief economist at the EU Council's secretariat. Despite this Merkel demonstratively abstains from grandstanding. "The challenge is not that a single country takes up a leadership role," she said. "It is very important that France and Germany get to an agreement and act together"[13]. But she failed to acknowledge that from the market's point of view France's economic credibility currently is weak, certainly at a lower level than Germany's. Merkel will for the time being have to get used to her leadership role.

DESIGNING AND BREAKING THE RULES-BASED APPROACH

The clandestine meeting took place at the end of the 2005 in the military section of Tegel Airport in Berlin. The EU's economic and monetary affairs commissioner Joaquín Almunia and his German director general Klaus Regling had travelled to Berlin to meet Angela Merkel and Peer Steinbrück before they were sworn into their respective jobs as chancellor and finance minister. The purpose of the confidential encounter was to end a conflict between the outgoing government of Social Democrat Chancellor Gerhard Schröder and the European Commission that dated back to 2003. Merkel and Steinbrück's message for their interlocutors from Brussels was clear and constructive: the new government wanted to respect the Stability and Growth Pact's (SGP) deficit limits, set an example and help the Commission to repair the damaged credibility of the euro area's budgetary rulebook. Merkel's Christian Democrats and Steinbrück's Social Democrats signed a coalition agreement that said that "the rules of the European Stability and Growth Pact will be abided by, the ensuing consequences for the consolidation of the public finances will be respected"[14].

Schröder, along with French President Jacques Chirac and Italian Prime Minister Silvio Berlusconi, had been responsible for a remarkable u-turn from previous German policy. This was best captured by a newspaper cartoon depicting a smiling chancellor comfortably sitting in his armchair while lighting his cigar with a burning letter containing the Commission's excessive deficit procedure against Germany. The three biggest euro-area economies had challenged the Commission's decision to start the disciplinary procedures foreseen in the SGP with regard to countries surpassing the three percent of GDP deficit limit. The countries even fought with the Commission at the European Court of Justice about the issue. Additionally they forced through a revision of the pact that strengthened its preventive arm destined to avoid the build up of deficits. But the revision also defined more exceptions for the three percent rule and gave deficit countries more time to get their finances in order. By doing so Schröder, Chirac and Berlusconi "have laid the axe to the pillars of the monetary union," former ECB chief economist Otmar Issing said[15].

People such as Issing, former Bundesbank President Hans Tietmeyer or former finance state secretary and today's ECB chief economist Jürgen Stark, are still outraged by Schröder's actions. According to them, the chancellor destroyed for reasons of petty political convenience what the preceding government under Helmut Kohl had built after long and painful negotiations.

Over the years the erroneous judgement has been established that acceptance of monetary union was the prize Germany had to pay for France's assent to reunification. That is wrong. Unity did create the political momentum for fixing a timeline for transforming monetary union into reality. But France did not have to pressure Kohl very much. He felt that firmly binding Germany into strong European structures helped ease its neighbours' fears and avoided reawakening nationalist or neutralist sentiments in Germany. The bottom line however is that Paris could not have prevented unity, especially not after the US and the Soviet Union gave the green light. Mitterrand knew this. "France would not be in a position to prevent reunification, should it happen," the president told a cabinet meeting already on 18 October 1989[16].

The real political bargain between France and Germany – first in the Maastricht Treaty and later in the SGP – was about the rules that would govern EMU. The Germans would accept giving up the mark if the French accepted that EMU be designed along German fiscal and monetary cultural lines: national responsibility for fiscal policies with strict rules for deficits and public debt, an independent ECB set up according to the rules and culture of the Bundesbank with a mandate to focus on price stability, a block on the ECB monetising public debt, and a no-bail-out clause. In other words, Germany's culture of stability was to be exported to the entire euro area. "The Treaty on Economic and Monetary Union, agreed after long and intense negotations, bears the German hallmark," Kohl's finance minister Theo Waigel later said[17]. "Our stability policy has become the leitmotif for the future European monetary order." In the minds of Issing, Tietmeyer and Stark, Chancellor Schröder had carelessly squandered what they considered to be one of the most important successes of German financial diplomacy.

The reality about the effectiveness of the rules was different however. From the beginning, politics never really played by the rules. Initially the Bundesbank thought that the Maastricht convergence criteria would only allow the D-Mark-bloc and France to take part in EMU. That zone would have been relatively homogenous, bearing some resemblance with an optimal currency area. But it was clear from the start that Belgium would be part of the club despite a debt level almost twice the 60 percent ceiling. Otherwise, it would have been necessary to dissolve an existing monetary union between Belgium und Luxemburg. Once Belgium was admitted on political grounds, there was no basis for denying entry to EU founding member Italy, although the third-largest EU economy had a similarly high debt level. On top of that it quickly became obvious that the German demand for an automatic sanction mechanism for countries with excessive deficits stood no chance of gaining support, and was even considered illegal by many[18]. It was thus clear before EMU even started that EMU would bend to political considerations, rather than observing the rules.

Nevertheless Merkel and Steinbrück thought it was crucial to rebuild the credibility of SGP. "As the German federal chancellor I am conscious of the extraordinary responsibility in this hour," Merkel said prior to the EU's March 2010 spring summit. "The German people have abandoned the deutschmark [and put their] trust in a stable euro. The entire federal government is united [in saying] that under no circumstances should this trust be betrayed"[19]. Merkel knows that the euro will lose all of its already fragile legitimacy among the Germans if they perceive it as a politically influenced soft currency. This is even truer today than it was in March.

NIGHTMARE OF COALITIONS

The common appearance of Chancellor Merkel and President Sarkozy after their meeting in Berlin on the Monday prior to the EU's June 2010 summit was greeted with relief in Brussels and other capitals. After weeks of squabbling, the two leaders presented the public with a compromise formula dealing with the contentious question of economic governance for the euro area. Sarkozy summed up the compromise, saying "we will have economic governance at the level of the 27 [EU member states] and in the event of necessity, there will be meetings concerning euro problems within the euro area"[20]. His statement took into account the chancellor's opposition to any institutionalisation of economic governance at the level of the heads of state or government of the 16 euro-area members. At the same time the compromise left the door open to those meetings on an ad hoc basis. Everyone present in Berlin that evening knew this was not the end of the 20-year Franco-German argument over economic governance of the euro area.

It is important to understand France's underlying reasons for pushing for economic governance. One cannot overstate the sense of alienation and defeat in parts of the French public and intellectual elite in the 1990s. For the sake of getting the single currency, Mitterrand had accepted stability culture. The president permitted the Banque de France to follow the Bundesbank's tight monetary policy despite a markedly different economic situation in France than in newly reunited Germany. "Not since Vichy were the political choices made in France so contrary to the national interest," the influential sociologist Emmanuel Todd said in 1995[21]. Pierre Bourdieu, another prominent French sociologist won much popularity with the left in 1996 when he labelled the philosophy underlying the Maastricht treaty "the Tietmeyer thinking"[22]. In a climate of general dissatisfaction with the economic policy choices of the conservative President Chirac, the left led by Lionel Jospin won parliamentary elections in 1997. One of their stated conditions for supporting EMU was the setting up of an economic governance structure in the future euro area and the pursuit of proactive growth and social policies. Kohl and Waigel finally accepted Jospin's demand to set up a 'Eurogroup' where the future euro-area finance ministers could informally coordinate policy positions with the ECB president and the EU's economic and monetary affairs commissioner.

Since this time, successive French governments have pushed for the Eurogroup to become a formal institution with the possibility of meetings on the leader's level. Paris has advanced this agenda considerably. The Lisbon Treaty has given the Eurogroup for the first time a legal existence. Sarkozy used the crisis to push through several Eurogroup meetings of heads of state or government.

But successive German governments have just as obstinately resisted the further institutionalisation of euro area economic governance. Their distrust goes back to the stated goal of former French presidents to limit the ECB's independence. "It is going to be politicians and not technocrats who will decide about economic policy and thus about the implementation of monetary policy," Mitterrand said in 1992. His successor Jacques Chirac underlined in 1996 the need for "a political power that is capable of showing monetary power clearly the limits of its action"[23].

German paranoia about the French motives prevented the Berlin governments from adopting the idea for use for the enforcement of the budgetary rules for euro-area members. This is particularly paradoxical because German former finance ministers admit that the Eurogroup in its present set up was and is unable to deliver such on enforcement. "We no longer trusted the Greek colleague with his figures," Hans Eichel, Chancellor Schröder's finance minister from 1999 to 2005, said. But nobody wanted to be unpleasant. "In retrospect I think we should have been a lot tougher with him," Eichel added[24]. "Nobody really confronted the Greek finance minister," another former finance minister remembers. "After the explanations of ECB President Trichet I always asked myself: oh my God, what is happening in this country?"[25]

Germany's current finance minister Schäuble draws the lessons learned from the Greek crisis and the inadequate governance within the euro area. "The past months have shown that a common currency requires a greater degree of coordination, however you want to call that in the end," he says[26]. But a Franco-German debate on substance is difficult because the French have never clearly outlined what form euro area economic governance should take. If one adds up the numerous vague announcements on the topic by Sarkozy and his economy minister Christine Lagarde, the aim seems to be for institutionalised meetings of the euro-area leaders, backed up by a permanent president and a secretariat with its own staff, possibly located in Paris. For a while, Sarkozy seemed to have toyed with the idea of becoming that president himself, but he appears to have abandoned this notion. The euro area governance institution's task would be to oversee the budgetary and macroeconomic policy of the 16 euro-area countries, and to correct undesirable developments such as excessive deficits or high export surpluses or deficits. The tasks at least could be rather sensible. But other statements, such as attacks by Lagarde on Germany's competitiveness, give reasons for a less benign reading[27]. Many in the German political and economic establishment suspect a French hidden agenda aimed at artificially weakening Germany's economic strength and at undermining its competitive advantage within the euro area and on the global stage.

Merkel has embraced the term 'economic governance' since February 2010 in an effort to find common ground with Sarkozy. But the chancellor insists it must cover all 27 EU members and deal exclusively with policy fields that are not integrated, such as wage developments, investment in science or national social security systems. Integrated policy fields like competition, internal market, trade or others should continue to be within the exclusive competence of the EU and dealt with through established procedures involving the Commission, the Council of Ministers and the European Parliament. The chancellor argues that only by involving all 27 countries can a split in the EU be avoided. For her it is crucial to have as close as possible a relationship with the big, important non-euro-countries such as Poland or the UK. Institutionalising the Eurogroup on the leader's level would alienate

Warsaw or London and thus not be in the German interest.

Furthermore for Merkel the Eurogroup creates a nightmare of coalitions. Germany is in a minority position on key issues such as fiscal prudence and a tight grip on European spending. In those fields, Germany's natural allies are the net payers in Scandinavia or the UK, and many central European countries who have adopted a German-style stability culture. Many of these countries are not euro-area members. Within the Eurogroup Merkel faces a strong front of southern European countries, often led by France. The chancellor fears that as net receiving EU members, they tend to be in favour of higher EU spending. Furthermore, she suspects that they have an economic culture where the German rules-based approach is not consensual.

THE VISION AND THE STATUS QUO

It could have been the opportunity to define a European vision. It was in May 2009 that Chancellor Merkel came to Berlin's Humboldt University to speak about Europe. It was here that foreign minister Joschka Fischer had nine years earlier detailed his vision of Europe's "finality" with a more federal and ambitious community[28]. Seen from today's perspective, the merit of Fischer's speech was that it launched a beauty contest that forced leading politicians such as Gerhard Schröder, Jacques Chirac and Tony Blair to explain their ideas about the EU. This remarkable debate created the climate for the establishment of the European Convention and, later, for the governments to draw up an EU Constitution.

But Merkel declined the opportunity to lay out her vision of the EU. "I will have to disappoint you on this point," she told her audience, "because I believe that defining long-term goals sometimes make it more difficult to take the next necessary political steps." The Lisbon Treaty, at that time not yet approved by the Irish in a second referendum, was the "best of our current efforts" in European integration, Merkel explained. She then went on to say that "the national states are the masters of the treaties" and that "we should avoid everything that leads to the transfer of competences through the back door"[29]. When delivering her speech, the chancellor knew that Germany's constitutional court was due to deliver its ruling on the Lisbon Treaty, and that this would most likely further limit the government's ability to relinquish sovereign powers to the EU.

But Merkel's refusal to spell out a European vision goes beyond political opportunism. "Even topics she feels deeply about, such as peace, liberty and securing of welfare, she deals with in an analytical and precise manner," explains a member of her government. "She is unemotional, it's part of her personality, but she is very good at delivering pragmatic solutions to given problems"[30]. In both domestic and European politics she does not know how to use the political mobilising force that visions can provide.

Guy Verhofstadt, who as Belgian prime minister worked closely with Merkel, remarks "she likes incremental steps, she has no vision for Europe"[31]. A senior minister who has worked closely with her in the previous government says, "throughout the four years in government I never understood what she wanted to achieve for Germany in Europe, where she wanted to position the country"[32].

Merkel's ambiguity over the EU is part of a deeper trend. In reality, the founding fathers' ambition of building a political union of comparable substance to EMU died during the negotiations over the Maastricht Treaty in the early 1990s. Helmut Kohl originally linked his assent to EMU to progress made on the forging of EU foreign and home affairs policies, as well as on increasing the competencies of the European Parliament in a real political union. "Our core goal remains at the end of the day the political union of Europe," the chancellor said on 29 April 1990 in Bonn. He insisted he would only present to the Bundestag a ratification document that contained substantial results on both the political union and EMU[33].

But France refused and Kohl soon realised there was nothing he could do against French foot dragging. Unlike EMU, which involved decades of detailed preparatory work, talks on political union quickly reached a stage of improvisation. By the end of 1990, the chancellor quietly dropped the link. During the debates surrounding the European Convention in the early 2000s, the idea of a political union was revived. But the French and Dutch no votes in 2005 killed the idea for the foreseeable future.

But there are also specific German reasons for Merkel's lack of vision. With the Lisbon Treaty ratified, the country has achieved all its strategic aims in Europe. Germany has peacefully reunited, while a single market, the euro and enlargement provide its export-oriented economy with excellent business opportunities without much in the way of exchange-rate risks. Germany exported its fiscal and monetary culture by convincing the rest of Europe to adopt stability culture and 'ordoliberalism', or the principle that governments should create a proper legal framework for the economy and ensure a healthy level of competition through measures that adhere to and promote market principles. The rules in the new treaty for taking decisions give Germany by far the biggest voting weight in the European Parliament and the Council of Ministers. With all that in place, it seemed rational from Merkel's and the political establishment's point of view to protect and strengthen a status quo that is tailored to the interests of her country. This, says Hubert Védrine, France's socialist former foreign minister, means that "the German longing for an ever further integration in Europe, typical of its European policy of earlier years, has disappeared"[34]. Jean-Louis Bourlanges, a French former liberal European Parliamentarian and an astute observer of EU affairs, agrees. "Germany has obtained what it wanted from Europe. Today the country is saturated"[35].

The non-existence of a political union today creates risks for the euro not foreseen by most of today's decision makers. It has become clear that for Europe the single currency is much more than a mere means of payment. In a consolidated nation state, a currency crisis is just a currency crisis. Its survival is not necessarily linked to the existence of the nation state. The euro bears all the weight of Europe's political aspirations to be seen as more than just an association of otherwise small and medium-sized sovereign nations. These aspirations would probably die if the euro died. Remarkably the ECB's chief economist Jürgen

Stark used this non-economic argument to justify the €750 billion stabilisation fund and the ECB's controversial decision to buy bonds of troubled euro governments on the secondary market. "Whoever questions the euro questions European integration," he warned. "The alternative is a fallback into the thinking of the nation state with all the negative experiences and consequences of the first half of the twentieth century"[36]. Merkel used similar rhetoric when she defended the package in Bundestag. "If the euro fails, all of Europe fails"[37].

OBSTACLES TO TOO MUCH EUROPE

When the constitutional court in Karlsruhe on 30 June 2009 declared the Lisbon Treaty to be in conformity with the German Basic Law (*Grundgesetz*, equivalent to the constitution), the ruling was greeted with relief in Berlin, Brussels and other EU capitals. Within the German government it was well known that a few of the conservative constitutional judges were much opposed to the treaty and had toyed with an outright rejection. It is true that in France, the Netherlands and Ireland, Europe's new rulebook had previously been rejected by popular votes. But in these countries the negative referendum result had not been the last word. The no votes had been overturned by a modified treaty and new elections. In Germany, a negative court ruling would have been without appeal. It would, after almost ten years of negotiations, failed popular votes, renegotiations and new votes, have definitively killed the Lisbon treaty.

In Germany's legalistic political culture, the constitutional court has defined the country's relationship with European integration through a series of landmark rulings. The judges have so far never ruled a European treaty to be incompatible with the Basic Law. But their rulings have imposed limits on how far the German government can go with integration and how the national legislator must be involved in the process. One of the main prior judgements was the Maastricht ruling of 1993, which defines "the aim of stability as the benchmark of the monetary union," and suggests that "in case the stability of the community fails, a dissociation (of Germany) from that community" is warranted[38].

Unlike Parliamentary or popular votes, constitutional court rulings cannot be overturned unless the court itself decides on modifications in a later judgement. Furthermore, Karlsruhe is the only constitutional court in the EU that does not accept that European law systematically overrules national law. Neither does it accept a relationship of legal subordination to the European Court of Justice in Luxembourg. Legal experts quickly agreed that Karlsruhe's Lisbon judgement would be a landmark ruling that would "shape the application of Union law in Germany for decades to come," in the words of EU law expert Martin Selmayr[39].

Although the court acknowledged the constitutionality of the Lisbon treaty, it ordered significant changes in the way the Bundestag has to be involved in EU decisions. The basic idea behind the ruling is that the government must not undermine the sovereignty of the German people when it abides by its constitutional duty to promote European unity. Therefore the Bundestag must have an active say in EU affairs. Furthermore, transfers of national competences to the European level must be decided by the Bundestag in the form of a formal German law. This court order was a reaction to the Karlsruhe hearings on the European arrest warrant of 2005. When asked by the judges to explain their assent to the warrant it became evident that the most senior parliamentarians in the Bundestag had almost no idea of the content of that EU legislation. But the judges are also serving some self interest by forcing the German parliament to codify their agreement to important European legislation through a German law. "If there has to be a German law, Karlsruhe has its foot in the door in all major EU decisions," says Werner Langen, who heads the German Christian Democratic parliamentarians in the European Parliament. "That way the court prevents loss of territory to the European Court of Justice"[40].

The judges also included a set of more general considerations that were seen as typical of the growing hostility of German society towards the EU. The court defined five sovereignty reserves in which they see no scope at all for further transfer to the EU: penal law, the monopoly of power for the police and the military, all basic fiscal decisions including social policy, and cultural and religious affairs. The judgement further states that the German Basic Law provides no cover for the government to participate in setting up a European federal state. Furthermore the court diminishes the legitimacy of the European Parliament by stating that it suffers from a structural democratic deficit that cannot be overcome.

Many in Germany praised the judgement as a definitive barrier against an ever-closer EU that the EU treaty asks for in its preamble. “The EU must not become a state, Germany remains a sovereign state,” commented Paul Kirchhof, a former influential Karlsruhe judge and prominent conservative eurosceptic. “As long as the Basic Law applies there will not be a United States of Europe”[41]. Heribert Prantl, an influential left of centre editorialist, called the ruling “spectacular, brilliant and wise”[42]. The fact that the judgement was welcomed by a majority of the commentators in the press on the right and the left indicates that the sceptical views of the Karlsruhe judges resonated well with considerable segments of public opinion.

There was also criticism, but it was a minority view and much came from outside Germany. Former foreign minister Fischer, one of the most outspoken pro-integrationists, criticised a “shocking” and “outrageous” ruling, because it “puts a permanent lock bar on any further institutional integration”[43]. Alfred Grosser, the German-born French political scientist, warned that the ruling left the worrying impression in the rest of the EU that “the Germans were never really serious about Europe”[44]. French liberal parliamentarian Sylvie Goulard warned the Germans about engaging in a dangerous “constitutional nationalism”[45].

Some legal experts from the EU institutions were dismayed at what they considered nationalistic regression on the part of the judges. The German social democrat Jo Leinen, former chairman of the European Parliament’s constitutional affairs committee, says Karlsruhe has created on its own initiative a “basic right for a nation state”, something not at all foreseen by the German constitution[46]. Former Advocate General at the European Court of Justice, Carl Otto Lenz, points out that the ruling uses the term ‘sovereignty’ 33 times while it is not mentioned even once in Germany’s constitution itself. By doing this the Karlsruhe judges could be seen as contradicting the constitution they are supposed to uphold[47]. For Klaus Heiner Lehne, a Christian Democrat and chairman of the European Parliament's legal affairs committee, the ruling is inspired by the legal and political "spirit of the nineteenth century"[48].

Clearly the ruling has rendered the German government's attitude to the strict respect of both national and EU law even more inflexible than before. "We have a very strong federal constitutional court, as became clear with respect to its ruling on the Lisbon Treaty," interior minister Thomas de Maizière said. "The idea that German law can be interpreted strictly on the one hand but that EU law can somehow be more political than legal, on the other, is not acceptable to Germany"[49]. A top official in the current government is even more direct, saying "this ruling puts us in a straightjacket. No government would politically survive another ruling like this"

The legal services of the Commission and the European Parliament fear that the court ruling could create problems for the good functioning of the EU, and may prevent further integration. "For the first time the constitutional court sets substantial limits on Germany's participation in European integration," the European Parliament's legal counsel warned. "The general tone of the ruling is: so far and no further. The court clearly implies in its ruling that European integration has reached the limits that are acceptable according to the Basic Law"[50]. An analysis by the Commission's legal service is even more straightforward. "The developments in the judgement on the principle of democracy seem to leave limited, if any, room for future transfers of competencies (beyond the Treaty of Lisbon) to the EU in its current institutional set up," it says[51].

The court and its new president Andreas Voßkuhle seem to have been taken aback by the concerns and hostile reactions the Lisbon ruling has caused in Germany and outside. As a consequence, Voßkuhle has engaged in a series of interviews, newspaper guest comments and speeches with the apparent intention of damage control. In a speech in Brussels, he stressed that in its Lisbon ruling Karlsruhe had created the new legal construction of the "Europe-friendliness" of the German constitution, which obliges government, parliament and the constitutional court to participate constructively in European integration[52].

THE ODD COUPLE

When Merkel first met Nicolas Sarkozy she warned him: “Nicolas, you will have to get used to the fact that I am slow”. The president subsequently had to learn this was no understatement. The French political system is centred around his energetic, instinct-driven character. It allows Sarkozy to take decisions on the spot – if necessary by ignoring the views of his government, advisors, parliamentarians and other stakeholders. With the chancellor it is the opposite. In the German federal system, decisions emerge after long, thorough and often controversial discussions with the chancellor playing the role of mediator. This slowness is reinforced by Merkel’s cautious personality, which is not noted for spontaneity and treasures an almost scientific way of preparing and taking decisions.

During the crisis the process was further complicated by obvious disagreements between Merkel and her finance minister Schäuble, the most senior member of her team. The lack of a central authority in the German political system and the resulting slowness and confusion are unimaginable in France’s highly centralised presidential system.

As a result Germany remains an enigma for Sarkozy. “In dealing with Merkel the president is permanently under the impression [that he is] being purposefully misled,” says an official who routinely sees both leaders interact[53]. On the other side the chancellor and her ministers perceive Sarkozy to be an “unguided missile,” as one government member puts it. So far neither has been able to find enough common ground to build a sustainable long-term relationship[54].

The lack of Franco-German consensus is an obstacle to the EU’s and particularly the euro area’s capacity to act. Contrary to conventional wisdom, EU enlargement has not diminished but rather increased the importance of common guidance. The 27 member governments are too numerous, heterogeneous and disorganised to agree on a political direction by themselves. No other pair or group of countries other than Germany and France have the will or the capacity to provide long-term leadership. But the current climate of misperception and distrust makes it difficult for Berlin and Paris to deliver common leadership.

In the crisis it was Merkel who imposed her conditions and designed the details of the solutions. Sarkozy added his touch and presented the result as a French victory. The most prominent examples are the Greek rescue package and the euro stabilisation fund. Merkel's dominance is reinforced by Sarkozy's current weakness. In normal times their relationship can be balanced. As a permanent member of the United Nations Security Council with intact armed forces, worldwide strategic interests and well-functioning international diplomacy, France is the lead nation when it comes foreign policy. But with the outbreak of the crisis, economic policy dominates the European agenda. Here Germany has the lead.

The chancellor never considered France to be an equal partner in this field. "Merkel considers that France must undertake reforms before becoming a really credible interlocutor," former Europe minister Jean-Pierre Jouyet already said on leaving office in early 2009[55]. But the crisis and the market's doubts about the sustainability of the public finances of many euro-area economies have put further pressure on France. Paris is now paying the price for not having put its public finances on a sustainable basis in recent times. "For 30 years our country hasn't produced a balanced budget," Europe minister Pierre Lellouche admitted[56]. With a deficit level significantly higher than Germany, Sarkozy and other French politicians are alarmed that markets might switch their attention from Greece, Spain or Italy to focus on France. A loss of the current AAA status, with the consequent increase in the cost of refinancing state debts, is the nightmare of the French political class. The worries seem justified. Budget minister François Baroin recently said it would be "challenging" to keep the top rating[57].

Until the weekend of 7-9 May, Sarkozy categorically opposed measures that could be interpreted as an austerity programme, and thus upset his chances for re-election in spring 2012. But pressure from his own allies such as Prime Minister François Fillon or National Assembly President Jean-François Copé is mounting. They want to once and for all reform the pension system, drastically rein in public expenditure and increase taxes.

As long as France's fragile position persists Sarkozy is more tied to Merkel than he would wish to be. Being seen as being close to Germany is critical for him in order to borrow credibility from Germany's sound market reputation. For the president it is crucial to succeed in his reform, if he wants to regain the status of a more equal partner. In an unbalanced relationship, it is difficult to build long-term political alliances. As long as the chancellor and the president are unable to create a sustainable long-term relationship, the markets will take home the message that in crisis times there is no political leadership in the euro area because the two most important members do not have an effectively functioning relationship.

GREEK TRAGEDY AND GERMAN DRAMA

When the fateful weekend of 7-9 May was over there was rapid agreement in Europe on who was to blame for the near collapse of the single currency: Angela Merkel. According to the mainstream view, the German chancellor's slowness and procrastination had transformed the local problem of a country that represents a mere 2.5 percent of the euro-area's GDP into a systemic crisis that put EMU at risk. In this situation, the euro could only be saved with an unprecedented rescue package, the reasoning went.

Had the issue been addressed more swiftly "the cost would have probably been lower, financially and especially politically," Commission President Barroso said[58]. ECB board member Lorenzo Bini-Smaghi even went as far as to accuse Merkel – without mentioning her name – to have willingly provoked the escalation of the crisis in order to convince the reluctant German public of the need for assistance for troubled Greece. "For example there was the thinking in a big euro-area country that you could get public assent for a rapid solution only by dramatising the situation," Bini-Smaghi said in a speech in Morocco. "But that thinking overlooked that in the midst of financial turbulence such dramatisation further fans the flames and increases the cost of rescue packages"[59].

Are these accusations justified? The weekend of 7-9 May was indeed a defining moment in the euro area's existence, a make -or-break situation. Since January 2010, key euro area protagonists confirmed privately that rescue plans for Greece which took into account Germany's specific constitutional requirements, had been hammered out and could be activated at any time by the leaders[60]. However no such decision had yet been taken. When the May weekend approached, investors' nerves were frayed after months of catastrophic news about Greece's public finances, half-hearted national counter measures, political tensions between Berlin and Athens, the threat of contagion spreading to other troubled countries like Portugal and Spain, and unconvincing aid promises by the euro-area partners. Against fierce initial opposition from French President Sarkozy and ECB President Trichet, the euro-area partners had even accepted Merkel's condition at their March 25 summit that the IMF become part of a Greek rescue scheme.

Merkel had a case until the March 2010 summit. Until then the Greek government had not entirely understood the gravity of their situation and thought they could escape without taking dramatic measures. But in the course of April, the chancellor's attitude became increasingly difficult to justify. A change of gear should have been made around 7 April when Greeks started to withdraw savings from their banks, the stocks of most major European banks came under strain and the debt crisis started to morph into a second banking crisis[61].

Two factors help explain the chancellor's behaviour. First the government was haunted by the spectre of a challenge and possible defeat over the Greek rescue package at the constitutional court. "We have to take Karlsruhe's conditions laid out in its ruling on monetary union extremely seriously," one cabinet minister said. "If we cannot convince the judges that the Greek rescue is a last resort action to safeguard the euro's stability and EMU's survival, the complainants will win their case"[62].

The second reason was electoral politics. On 9 May, Merkel faced a crucial regional election in Nordrhein-Westfalen, Germany's biggest federal state with a population larger than that of the Netherlands. The chancellor knew that a defeat of this state's centre-right coalition would mean the loss of the majority in the Bundesrat, the powerful upper house and co-legislator. Merkel also knew that almost two thirds of Germans thought that the euro had been disadvantageous for them[63]. When she had seemed to rule out any help for Greece, Europe's biggest-selling daily *Bild* had depicted her as a Bismarck-style iron-chancellor statue and applauded her under the headline: "Never again Europe's paymaster!"[64] It seemed that providing billions in rescue loans to prop up the unsound Greek economy was going to be a sure vote loser.

In the days before the fateful euro-area leaders' 7 May gathering, there had been alarming developments on the markets. Increasingly, banks refused government bonds as collateral not only from Greece, but also from Spain, Portugal, Ireland and Italy. According to some reports, only German bunds were still widely accepted; even French bonds were no longer sellable. "We noticed Thursday and Friday a panic attitude among many market participants," ECB chief economist Stark said[65]. In conference calls with bank traders, and in a joint letter from the biggest bank's CEOs, the ECB was urged to stabilise the markets as the buyer of last resort. "We made clear to them that it was really necessary to step into the markets," Sander Schol, director of the Association for Financial Markets in Europe, said. "There were no buyers at that point. We felt that if the ECB would announce that they would operate as a buyer, the markets would know there was a floor to the prices"[66]. Additionally US President Barack Obama's administration started to put pressure on the Europeans because he feared that the virus of market distrust would jump from the troubled southern European euro-area countries to Britain and the US. "Seen from Washington and New York, Europe was in a situation just like the US before the collapse of Lehman brothers," a key euro-area player said. "The Americans appealed to us:

fix it over the weekend," another said[67].

ECB President Trichet briefed the euro-area leaders in Brussels on the evening of Friday 7 May using charts illustrating what had happened on the markets in the last few days. According to participants, he was put under enormous pressure from Sarkozy to forego the treaty prohibition against monetising public debt. The French president was supported on this point by the prime ministers of Italy, Portugal and Spain. Merkel did not disagree on substance but sought to protect Trichet from the pressure Sarkozy and his followers exercised. She insisted that ECB independence had to be respected, that hectoring of the bank had to stop and that the heads of state and government and the ECB president had to "trust each other"[68]. In the meeting Trichet did not commit, saying to the heads of state and government "you do your job, I do mine". According to Peter Ludlow's insider account of the Council meeting, Merkel went to see Trichet before leaving the meeting and told him, "we have every confidence that you will do what you need to do". Ludlow concludes from this that Merkel and Trichet by that time may already have concluded that the purchase of bonds would have to be part of the euro area's response to the market turmoil. Their main concern was rather that Sarkozy's clumsy pressure did not create a situation in which Trichet would have been unable to convince the ECB council that the bond purchase was the only thing to do.

Late that night the leaders agreed on the €110 billion rescue package for Greece, jointly financed and implemented by the euro-area countries and the IMF. But they knew this would not be enough to calm the markets. "We have decided to put into place a European intervention mechanism in order to preserve financial stability in Europe," Sarkozy said to a late night press conference[69]. Further details would be worked out by the EU finance ministers and announced Sunday night before the first stock markets in Asia opened after the weekend, he added. Standing in front of the 16 euro-area members' flags the French president clearly tried to use the opportunity to present himself as the saviour of the common currency, claiming that "95 percent" of what had been decided was according to French design. Merkel did not try to steal the limelight from him. She left the Brussels Council building through the back door, barely saying a few short sentences to the TV cameras, looking worn and defeated.

When the EU finance ministers announced a €750 billion stabilisation fund jointly financed by the EU budget, the euro-area governments and the IMF very early on the Monday morning, they left the impression that they had dramatically altered the rules that Germany had imposed as the basis of EMU. This impression was reinforced by the press release the ECB had issued minutes earlier announcing "measure to address severe tensions in financial markets", the central bank's euphemism for buying government bonds.

But that impression does not withstand closer scrutiny. The Germans had secured crucial concessions. They had refused an EU solution. Only €60 billion was to come from EU funds. €440 billion would be raised and distributed through a Special Purpose Vehicle (SPV) under Luxembourg law as bilateral loans. "Concretely there was the threat of a 'transfer union', in which a direct and binding liability of all would have been introduced for decisions taken by individual governments," Merkel explained after the weekend[70].

Nevertheless there was a sense of bitter defeat in Germany. Privately some people in government consider that the whole operation was a collective agreement of the euro-area governments to violate the treaty and its foundations for EMU. But no alternative was available, they point out. To stick to the letter of the treaty would have meant risking the destruction of the euro on Monday morning. Many people however felt that Merkel's iron-chancellor strategy had lamentably failed.

Domestically, the elections in Nordrhein-Westfalen were a disaster for the chancellor's party, because the ruling coalition with the liberals clearly lost its majority. On the euro decisions many Germans felt that Sarkozy was right that "95 percent" of what had been decided over the weekend was based on French ideas, something very different from what they had been told when the euro was introduced in 1999.

EURO DISSIDENCE AND TOUGH LOVE

The weekend's decisions were perceived as catastrophic in Germany. "Once again we are the fools of Europe," the headline of mass-circulation daily *Bild* read, adding, "€750 billion for bankrupt neighbours, but our tax reduction is scrapped"[71]. The highbrow *Frankfurter Allgemeine Zeitung* also issued a devastating judgement: "Since a transfer union has been effectively introduced and the central bank is now under political command, the fate of the euro as a soft currency and the failure of the monetary union are certain," its editorial said. "Whoever holds savings or pension contracts should now be prepared for devaluation in the long run[72].

According to a poll carried out by the DGZ-Bank, 44 percent of Germans would like to scrap the euro immediately and have the deutschmark back[73]. And a poll by Forsa Institut found that 54 percent of Germans now fear rising inflation[74]. In the days after the summit, it seemed impossible in Germany to turn on the television without finding a talk show on inflation, a weak euro or monetary reform.

Based on such anecdotal evidence, the May decisions have provoked an emotional divorce between parts of German public opinion and the euro. In addition, former and current top euro-area officials have let it be known that they are in a dissident position within the euro area regarding the exceptional May weekend's decisions. "The basis of the euro has fundamentally changed since the governments of the euro area have decided [to form] a mutual bail-out association," Karl Otto Pöhl, president of the Bundesbank from 1980 to 1991 commented. "You will see how much we Germans will have to pay for all this"[75]. Current Bundesbank President Axel Weber distanced himself from the ECB's decision to buy government bonds. "Buying bonds contains considerable stability policy risks and therefore I am critical of this decision by the ECB council even in this extraordinary situation"[76]. It was the first time that an ECB council member broke the rule of public solidarity on decision in which he had participated taken by the body.

A political backlash is likely. Even within the highest ranks of the

German government there are fears that a talented charismatic populist might score very well on an anti-euro or pro-deutschmark platform. "Once there is a person like Oskar Lafontaine was on the left, such a party could easily score 15 or more percent," some within government say[77].

Public comments about the May weekend's decisions question the German government's insistence that no breach of the treaty, no bail out and no transfer union has been organised. "It is an enormous change," said French Europe Minister Pierre Lellouche. "It is expressly forbidden in the treaties by the famous no bail-out clause. *De facto*, we have changed the treaty," he added. Lellouche went on to liken the €440 billion euro mechanism to a NATO-style mutual defence clause applied to the euro area. "When one member is under attack, the others are obliged to come to its defence"[78]. For Merkel such a statement is a disaster. Complaints against the Greek rescue package and the euro stabilisation mechanism have been filed at the constitutional court in Karlsruhe with the plaintiffs very much arguing along the same lines.

But the chancellor soon afterwards decided to regain the initiative. She tried to reassure her fellow Germans by choosing a tough love approach for Europe and the euro area. Fiscal and budgetary policy in the currency area would have to be much more closely coordinated. "And with a closer interlinkage of budgetary and economic policies in Europe it is not the weakest who will decide how committed we are to make it work, but the strongest," she warned[79]. In an interview for a French audience she stated, "for Germany, this culture of stability and solidity is not negotiable"[80].

Merkel knows that she has to walk away from the negotiations about the strengthening of the rules with a visible victory if she wants to win over at least some of the Germans who were put off by the Greek rescue package and the euro stabilisation mechanism.

Finance minister Schäuble issued by mid May tough proposals for the working group of EU finance ministers, headed by European Council President Van Rompuy, to strengthen economic governance in Europe.

Schäuble is urging the other countries to consider adopting a rule similar to the German debt brake, which will tightly restrict the government's ability to run deficits. "In Germany, for example, we have introduced a constitutional limit on borrowing, which is deliberately aligned with the medium-term budgetary objective of the Stability and Growth Pact," he argued in his proposals for the Van Rompuy group[81].

Furthermore, Schäuble's proposals include an automatic and more speedy escalation of the excessive deficit procedure for serial deficit offenders, the suspension of the voting rights of serious budgetary rules violators and an orderly insolvency procedure for defaulting euro-area states. In extreme cases, a decision could be made to permanently revoke EU Structural Funds that had been withheld from serial offenders. The German government insists that treaty changes should be no longer treated as a taboo and should be envisaged if needed to make those measures more credible.

Furthermore the constitutional debt limit and the national consolidation package amounting to €80 billion up to 2014 puts huge pressure on all other euro-area countries to do likewise. Those measures were enough for Le Monde to put the headline "Germany imposes its vision of economic Europe" on its front page[82]. But it will probably not be enough to make angry Germans more positive about Europe.

CONCLUSION: WINNING THE DEBATE AND LOSING PUBLIC OPINION

At a distance, the initial anger and outrage in Germany about the crises surrounding Greece and the euro may appear surprising. In the crisis negotiations Chancellor Merkel got almost everything she wanted. The assertion of President Sarkozy that the deal was 95 percent French thinking does not stand up to closer examination. It was explicitly against his will that the IMF was made an integral part of the rescue package for Greece now and will also be an essential part of any future assistance offered to other euro-area countries, should they need to activate help from the euro stabilisation fund. The solutions were found at the last possible moment and therefore corresponded to the requirement of an '*ultima ratio*'. Thus Berlin will be able to argue in the forthcoming hearings at the constitutional court that it was not about helping a particular country. The government's lawyers can make the case that the chancellor had no choice if she wanted to preserve the stability of the euro, secure the survival of EMU and act in the interest of the German people, as her oath of office requires her to do.

Her conditions were met on all the technicalities as well. The rescue loans for Greece have been granted on a bilateral basis. Of the €500 billion of the euro stabilisation fund, €440 billion comes from the member states. An additional €250 billion is supposed to come from the IMF. The euro stabilisation fund, which will have the tasks of borrowing up to €440 billion and disbursing emergency loans to assist troubled euro-area states, is a new legal entity separate from EU institutions and set up under Luxembourg law. Loans can only be granted by a unanimous decision of the euro-area governments. To avoid any impression of the establishment of a permanent transfer union, it can only go to the markets for the limited time of three years. And to dispel any fear of an organisation run by potential 'Club Med' beneficiaries, the top German official, and fiscally hawkish former director-general of EU economic affairs commissioners Pedro Solbes and Joaquín Almunia, Klaus Regling was put at its helm.

To this may be added that longstanding German requests to its euro-area partners on structural reforms and budget consolidation have been met since the weekend of 7-9 May. Under severe pressure from the markets, euro-area countries such as France, Italy, Portugal and Spain have announced unprecedented measures to get their social security systems and public finances onto a sound footing.

Despite all of this, the disgruntlement of the German political establishment, many economists, considerable parts of the media and the public persists. In order to overcome their emotional divorce from EMU, the system's rules need to be rewritten and its governance needs to be redefined. Cheating and open non-respect of the agreed limits must be rendered impossible, dysfunctional governance must be decisively improved. The question whether Germany will and can once again be the benevolent hegemon in the EU and the euro area will determine whether a sustainable recast of the currency area can be achieved.

Judging from the recent past, doubts are warranted. In the current political climate any politician seen as actively engaged in rescuing a euro-area country or reforming the euro area is putting him- or herself on a losing path electorally. Former Finance Minister Steinbrück said for the first time in February 2009 that there would be rescue measures for Greece if needed. But there was no follow-up because his remark calmed the markets for the time being and no one in Germany wanted to be associated with the topic before the federal elections later on that year. When the Greek crisis became serious again at the beginning of 2010, Merkel also at first chose to wait and see. This is not surprising given the current lack of popularity of the EU and the euro among the political class, the economic elites, the press and the population. Strong doubts were warranted.

The scope of euro-area reform is also limited for the moment because of Germany's reluctance to transfer any further competencies to EU institutions. In some respects Berlin has been constructive recently. The government agreed to grant more controlling power to Eurostat and to let the Commission keep an eye on the drafting of national budgets. But otherwise well-defined barriers remain to handing over more powers to Brussels, as a result of the constitutional court's rulings. Furthermore, the Merkel government has a general mistrust of the Commission and its President Barroso in particular. Seen from Berlin the institution is motivated by a power grab and has not shown its capacity to carry out effective budgetary surveillance. As a result Germany wants as much decision-making responsibility as possible at intergovernmental level.

There are political costs to the German intergovernmental approach, however. The government's intention with the €750 billion stabilisation fund was to impress the markets with volume. But the month-long tortuous arguments between the governments prior to the decision on Greece and the euro stabilisation fund, as well as the complicated intergovernmental design of the SPV, served to neutralise the impression of huge volume. It showed that former ECB chief economist Issing's description of the EMU remained valid after the crisis. "Member states are still sovereign," Issing wrote at the beginning of the crisis in February. "EMU does not represent a state; it as an institutional arrangement unique in history"[83]. The markets are left wondering whether this institutional arrangement unique in history will be able to manage the next crisis more efficiently. The insistence on the potentially inefficient intergovernmental set-up is a major reason for doubts about EMU's chances of long-term survival.

HOW TO GET GERMANY REENGAGED WITH EUROPE

Germany's dominant role in the EU, and all the more so in the euro area, is a reality. This situation will last at least as long as the financial and economic crisis dictates the agenda. The current dissident mood in Germany is worrying. Germans will not easily be convinced to fall back in love with the EU. But it is in Germany's and in Europe's best interest that the country overcomes the disenchantment brought on by the euro crisis and uses its powerful special role in Europe constructively. The German government can help that process along, provided there is political will to provide the necessary leadership.

The first point concerns 'the vision thing'. The political narrative on Europe has got lost in the past few years. A diffuse, positive feeling among the German population towards EU integration has been replaced by indifference and scepticism. The government should work on a new narrative that helps to recreate a pro-European consensus. Some pragmatists may consider this as rather esoteric. But it is short-sighted to ignore the crucial importance of ideas, vision and a sense of purpose for mobilising political energy. Chancellor Merkel is right to focus on delivery of what was promised in the past. Eternal talk about grandiose European projects like the Galileo satellite system or the Iter fusion reactor, with their ever-increasing costs and no result in sight, feeds cynicism. But focusing on delivery is not in contradiction with defining a political horizon that is worth a political effort. Not to do that is bad politics. Voters need to know why things may have to be done that appear politically or economically costly in the short run if they are likely to pay off in the long run.

The euro crisis has brought about a state of mind in Germany that is worrying. It would have been the government's responsibility to explain from the start why a situation may arise in which it is in Germany's best interests to assist Greece in order to save the euro. And it would have been the responsibility of Germany's political class to confront the mass-circulation daily *Bild* newspaper with its sometimes chauvinistic reporting and to comment on Greece more vigorously. Germany's politicians allowed a mood to settle that suggested the country had fallen victim to a conspiracy of the southern European countries.

The elements of a European narrative for Germany are obvious. Everybody understands that European integration is the basis of the country's success after the war, its rise as one of the leading world economies and its peaceful reunification. It is not difficult to explain that a highly export-oriented economy benefits from the euro and the elimination of exchange-rate fluctuations within the currency zone. Most Germans see that the euro's significance is not limited to economic interests. The other EU countries are reassured to see that the biggest and most powerful member state was ready to share parts of its sovereignty in EMU. Maintaining and developing this is crucial for Germany's future. "We are a community of destiny," Finance Minister Schäuble said. "If Europe is doing well, Germany profits more from that than anybody else. Therefore we promote our interests best by feeling co-responsible for the others. The condition for this is the acceptance of the stability rules by everybody"[84].

Germany may be big by European standards but it is small on a global scale. Worldwide influence and protection from global threats are no longer possible in a purely national framework. It is only within the frameworks of the EU and the euro area that Germany will be able to be an international player.

Most of this Chancellor Merkel has said. But during the euro crisis she said it too late and did not make herself heard. She had little impact on public opinion. If she wants to overcome euroscepticism in Germany and wishes a pro-European attitude to become mainstream again she must find more convincing ways to communicate this topic.

A second issue is Germany's relationship with France: Merkel's personal relationship with French President Sarkozy is, according to my contacts, bad. This is the fault of neither. They are different characters and both are operating under difficult domestic circumstances. The chancellor should nevertheless try to build a strong political relationship with her most important partner in Europe. Germany will not be able to exercise its leadership role efficiently by itself because resistance from other countries will most likely increase. On top of this, co-leadership between Berlin and Paris has a pragmatic advantage. Especially in economic policy, France will bring arguments to the table that other southern European countries would raise anyway. Finding a Franco-German compromise therefore is a more organised and efficient way of reaching a solution than a complicated multilateral negotiation with everybody.

Finding common ground with Sarkozy is going to be difficult. The French president is likely to be weak at a moment when he cannot afford to be seen as weak. He is under enormous pressure from the markets to impose tough austerity measures on his country, something he categorically ruled out until late spring 2010. Sarkozy is facing a dangerous dilemma. Any failure to deliver on reforms may endanger France's reputation as a credible borrower and trigger a downgrade from its current AAA status. Delivery on the reforms, however, might compromise his chances of re-election in 2012. In this context Sarkozy will be an even more unpredictable partner for Merkel than he has been so far.

Past chancellors and presidents have sometimes struck grand bargains that led to the realisation of major projects like the EMS for Helmut Schmidt and Valéry Giscard D'Estaing and EMU for Helmut Kohl and François Mitterrand. The economic governance of the euro area should be such a project for Merkel and Sarkozy.

A third point is about the euro area's repair. There is a communication issue and a substance issue. After the weekend of 7-9 May, most people in Germany feel the founding principles of the euro have been thrown overboard. Confidence in the single currency has diminished. The redesign of euro-area governance must be carried out in a way that helps to regain lost trust and should be communicated in a way which supports that. Choosing Bundesbank President Weber to succeed to Jean-Claude Trichet at the helm of the ECB may be a central part of a communication strategy to reconquer public opinion for the euro.

The substance issue is that the crisis has shown that EMU has so far been a fair-weather project. Rules were not abided by, sanctions were hardly ever imposed, their use was highly politicised. So depoliticising sanctions and triggering them according to the budgetary track record of the country in question seems to be the right approach. Additionally, Germany should insist on developing a procedure for the orderly insolvency of euro-area countries. If done properly this would require a treaty change, and Berlin should insist on lifting the taboo on treaty changes.

The SGP is mainly about fiscal discipline whereas not all important problems threatening the euro area are fiscal. The problems of diverging competitiveness between euro-area countries are inadequately addressed by the pact. Spain and Ireland until recently respected the budgetary rules. They could not be held accountable for the build-up of unsustainable bubbles in the housing sector because of the fiscal focus of the current rules. Therefore a new framework must take into account competitiveness issues.

While Germany's engagement in the task force of European Council President Herman Van Rompuy is laudable, it focuses too much on rules and sanctions. There is a logical contradiction in German political and economic thinking. It is puzzling to see so much faith in more and tougher rules and sanctions when the past has seen disregard for the existing rules and sanctions. The reality in the euro area shows that a rules-based approach does not work if there is no deeply rooted political consensus behind it.

While this consensus may exist in Germany most of the time, it does not exist in many other euro-area countries. Many governments appear to invest more energy in circumventing the SGP rules and than in respecting them. Also, it is unlikely that an inflexible approach modelled on budgetary limits is a useful tool for monitoring member countries' competitiveness developments. All this considered together pleads in favour of euro-area economic governance. Germany should take the driver's seat in the debate on the economic governance of the euro area in order to form it according to its interests. Trying to sabotage an idea that it cannot kill and that is potentially useful is a waste of political energy.

A fourth point concerns the constitutional court. Germany should reflect upon the role that its constitutional court has started to assume. In its Lisbon ruling it has limited the government's room for manoeuvre more than any other comparable court in Europe. With its general considerations about German sovereignty it has tied down the future legislator in a way that raises questions. The Karlsruhe court enjoys enormous legitimacy in Germany. Therefore it is more likely that this and future governments will respect the limits set out by the judges rather than start a discussion about the court's role in defining German European policy. But the question remains if German EU policy is not destined to be more and more at odds with that of the rest of the EU as a consequence of the constitutional court's rulings.

Karlsruhe raises questions that are overlooked inside Germany. The court has acquired almost exterritorial jurisdiction over EU economic policy. During the Greek and euro crises no rescue plan was possible without Germany. So, *de facto*, the judges' limits applied to the entire euro area, and the votes in the German Bundestag in effect became votes relevant for the whole currency area. It is not surprising that this creates tensions and frustration in other member states.

A final point concerns transfers in the euro area. Germany should reconsider its categorical refusal of additional transfers within the currency area. So far most of the less-developed countries on the rim of the euro area have enjoyed higher growth than those at the centre such as

Germany. Having embarked on ambitious consolidation and tough structural reforms, countries like Greece, Portugal, Spain and potentially others face a painful decade of weak growth, low wages and high unemployment. Social unrest and domestic political pressure on governments to leave the euro area with the aim of easing adjustment through devaluation may become a problem.

Germany may face the situation where EMU in its current composition can only be kept alive if Germany and the other affluent euro-area countries are willing to provide for some additional transfers. The decision will be difficult. In the present political climate in Germany new transfers would probably be unsellable. But the decision might have far-reaching consequences, including the exit of individual countries or of the entire southern bloc from the current euro area. In the latter case, there may even be a split into two areas, one evolving around Germany, the other around France. But a split of the euro area along the Rhine would throw into disarray the entire political logic of EU integration and EMU with incalculable consequences for Europe as a whole.

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