CENTRE FOR EUROPEAN REFORM
briefing note

Germany, the euro and the politics of the bail-out

By Katinka Barysch

★ It took Berlin months finally to support a financial aid package for Greece and other struggling eurozone countries. Accused of lacking European solidarity, the Germans have reacted with defiance, even anger.

★ Chancellor Angela Merkel's leadership style and domestic political constraints contributed to Berlin's hesitancy during the euro crisis. However, underlying shifts in Germany's stance towards the EU mean that any government will take a more hard-nosed approach to European policy-making.

★ The current rift between Germany and its European partners needs to be handled carefully. The implications of a more eurosceptic Germany for the future of European integration would be severe.

On May 2nd, eurozone finance ministers, the IMF and the Greek government agreed on a loan package for Greece worth up to €110 billion over three years. The decision came more than one month after EU leaders had agreed on the broad outlines of financial support and two and half months after they first discussed the option of helping Greece. Most people blamed Berlin for the delay. Angela Merkel's hesitancy and prevarication increased the cost of the bail-out, unsettled financial markets and poisoned the political atmosphere in Europe. Some commentators have accused Germany of being selfish, lacking solidarity with its EU partners, and putting domestic politics ahead of the survival of the euro. Analysts have concluded that Merkel simply does not 'get' financial markets. Those with a knack for conspiracy theories mused whether Berlin had dragged its feet in the hope that Portugal, Greece and Spain would be forced out of the euro, leaving only 'stability oriented' northerners within the single currency.

After the May 2nd deal, it took the Europeans only another week to agree on a second, much bigger financial support package for the other eurozone countries: a total of €750 billion, of which €440 billion would come in the form of loans guaranteed by individual EU countries. Unlike the loan to Greece, which is already being disbursed, the second package is meant as a safety net in case Portugal, Spain or Ireland struggle to fund themselves in the bond markets.

As the eurozone's largest member, Germany is the single biggest contributor to both deals: €23 billion for the Greek bail-out and potentially €120 billion in guaranteed loans for the second package. Yet the criticism of Germany has not died down. Many Germans admit that Merkel's tardy decision-making made the bail-out more expensive. However, they plead understanding by pointing to domestic political constraints: belligerent public opinion, a crucial election in Germany's biggest state and a looming case at the constitutional court, not to mention occasional dissonance between the chancellery and the finance ministry. More importantly, they argue that if the EU countries had just handed over money to Greece without tough conditions attached, the sums would have been wasted. Unless the markets believe that the bail-out triggers sustainable fiscal consolidation,

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the eurozone may unravel. Since Germany sees itself as Europe's traditional monetary anchor, it felt responsible for forcing Greece and other South European countries back on to the path of fiscal rectitude.

What Berlin wants

When Germany reluctantly gave up the Deutschmark, it insisted that the eurozone should be anchored in the same 'stability culture' that had underpinned its national currency. But the framework the EU put in place to achieve this has not delivered, in no small part because Germany itself, alongside France, watered down the fiscal rules of the 'stability and growth pact'. Germany now feels stuck in a monetary union with countries that it cannot trust ("The Greeks lied to us," is a common refrain in Berlin circles) and with rules that do not work. Berlin is determined to strengthen the rules and enforcement mechanisms that underpin the euro in a way that prevents a repeat of the current crisis.

The to-do list that Finance Minister Wolfgang Schäuble presented to the EU's new working group on eurozone governance on May 22nd suggests that Germany's aim is to make the rest of the eurozone look more like itself. His list included much tougher sanctions on those countries that do not comply with EU fiscal rules and national legislation, in all eurozone countries, that forces them to stabilise the national debt (mimicking Germany's own constitutional amendment that requires the government to eliminate deficits from 2016 onwards).

From a macro-economic point of view, Berlin's idea is flawed. The South European countries need stronger demand for their exports. Otherwise their fierce fiscal austerity programmes will drag their economies into a prolonged and probably unsustainable slump. Export demand will have to come from those countries that are currently running big external surpluses, most notably Germany.

The eurozone needs a mechanism to prevent the kind of divergences and imbalances that have contributed to the current crisis. Yet many Germans still struggle to acknowledge that a 'rebalancing' of the European economy also requires them to change. If anything, they see the eurozone crisis as proof that their economic model is the right one: saving is superior to spending; wage restraint guarantees competitiveness; exports are better than imports. Rather than engaging in a debate about how the eurozone economy could be rebalanced, Merkel's government quickly enacted another austerity package in June, arguing that it was upon Germany to lead Europe back to fiscal responsibility.

In the debate about what kind of institutional and legal changes the eurozone will need to survive, Berlin also disagrees with its EU partners, most notably France. Paris has used the euro crisis to push for its long-held belief that the eurozone needs an 'economic government' – a political body made up of leaders from the 16 euro members that co-ordinates economic policies and presents a counterweight to the ECB. Germany wants to keep any economic policy co-ordination at the EU level of 27 member-states, because it seeks to dilute France's influence and because it fears for the independence of the ECB. Merkel and Schäuble have said the EU should not shy away from re-writing its treaties to strengthen the euro's framework. Most other EU governments are unenthusiastic, not least since treaty change would require another lengthy and politically risky round of ratifications in 27 national parliaments, as well as a series of referendums.

Germany's changing stance towards the EU

Although France and Germany managed to paper over their differences in the run-up to the June EU summit, the Germans are in no real mood to compromise. Perhaps for the first time since the Second World War, they are allowing themselves to be defiant and proud. Their export-oriented, stability-obsessed economic model is not up for discussion. Their participation in the eurozone is becoming more conditional. Even the wisdom of the whole EU project is now sometimes questioned.

Germany's rebellious reaction to the eurozone crisis has surprised many. But the country's attitude towards the European Union has been cooling for over a decade. Underlying this shift are a number of structural and historical factors:

* The weight of history is lifting

For the first four decades after the war, the Germans' main aim was to merge into the European Union and NATO. Post-war Germany could have a foreign policy only as part of a European club or a western alliance.

It was European integration that gave Germany the freedom to act. Within the EU (or EEC, at the time), Germany liked to assume the role of a bridge and broker – between big and small countries, between the national governments and the EU's Brussels institutions, between Gaullist France and Atlanticist Britain. The Germans saw their role often as a forger of compromise and they were happy to pay for it if needed. This was Helmut Kohl's famous chequebook diplomacy.

Today, many Germans think they have paid their historical dues. Gone is the generation with a vivid memory of the horrors of the war. Already with Gerhard Schröder, Germany had a chancellor who was much less emotionally attached, much less idealistic about the European idea. Merkel has continued this shift. For the generation of Helmut Kohl, Europe was a matter of war and peace. For Merkel and most of her contemporaries, it is a question of costs and benefits.

* Europe's new geopolitics

The fall of the iron curtain transformed Germany's European policies in three significant ways. First, during the Cold War years, Germany was a frontline state. Membership of NATO and the EU were seen as a matter of survival. Following the accession of ten former Warsaw Pact countries to the EU, Germany is now surrounded by friends. In such a safe environment, Germany can define its national interests differently.

Second, eastward enlargement has changed the political dynamics of the EU. In a Union with 27 member-states, Germany can no longer equate its national interest with that of the EU, even if it wants to. The EU is simply too big and too diverse. In areas ranging from car exhaust fumes to China policy, German interests are often different from those of some European neighbours. Berlin is usually willing to compromise. But since the Germans no longer assume that there is such a thing as an 'EU interest', they are learning to look at their own needs differently.

Finally, of course, the end of the Cold War and the fall of the Berlin Wall brought about the reunification of western and eastern Germany. Because reunification was hugely complicated and expensive, it has made Germany more inward-looking and less generous. The Germans insist that they simply cannot afford to be the paymaster of Europe any more.

* Shifting attitudes

It would be wrong to look back at the eras of Helmut Schmidt and Helmut Kohl with bleary-eyed nostalgia: Germany has always been willing to stand up for its interests in Europe and it has at times antagonised its neighbours in doing so. Nevertheless, there has been a noticeable and important change in sentiment in recent years.

Germany's traditionally pro-EU elites appear detached from the European cause. Even the few remaining federalists now rarely make the case for deeper and faster European integration. They grumble that when they tried to move European integration forward, their fellow members wanted nothing of it. Various German politicians in the 1990s argued that a common currency would have to be underpinned by some kind of political union. When in 1994 Wolfgang Schäuble (then a leading member of parliament) and his CDU colleague Karl Lamers sketched out a quasi-federalist union around a core group of countries, France replied that the time for grand ideas like these had passed. Another defining moment came in 2005, when French and Dutch voters rejected the EU's constitutional treaty in national referendums. The fact that two fellow founding-members of the EU could do something so un-European appeared to liberate the Germans to take a more critical stance towards the EU.

The European debate in the media has also changed. For over 40 years, Germany's newspaper editors, radio reporters and TV presenters were almost uniformly pro-European. Many are now asking questions about Germany's membership of the euro and the EU that were previously unthinkable. Perhaps a proper European debate was overdue in Germany. But it starts at a time when the eurozone crisis has whipped up a nasty sense of public indignation. The lack of political leadership on the Greek bail-out left the media free to set the tone of the debate. That tone has ranged from the doubtful to the visceral. Day after day, Bild – Germany's most widely read and influential tabloid – has run stories about Greeks retiring at 50 and dodging their taxes. "We give you cash, you give us Korfu," ran one headline that particularly upset the Greeks. The media portrayed Germany's contribution to the rescue packages as a straight cash transfer, rather than a publicly guaranteed loan. Children, the elderly and the poor in Germany would invariably suffer, the media argued.

Germany's elites are fully aware how much their country has benefited from the EU: it has gained markets for its exports, a common currency that is stable but not too strong, friendly neighbours and the ability to act on the world stage. But successive German governments – as well as Germany's business leaders and newspaper editors – have been surprisingly reticent when explaining these benefits to the Germany people. Many ordinary Germans seem to think that EU integration is a sacrifice that they have made for the benefit of other European countries.

The Germans are still happy to express support for the EU on a general level (53 per cent said their country's membership was a good thing in the autumn of 2009). But their enthusiasm falters when it comes to making sacrifices. It was easy for them to cheer for European integration as long as it was just a 'vision thing'. Now Europe is arguably undergoing its first reality test. And the reality is that the Germans do not feel enough solidarity with their southern neighbours to pay for the costs of their fiscal mistakes or burst property bubbles. Various surveys conducted during the negotiations of the bail-out packages showed that a big majority of Germans were against making any EU or German money available to Greece, even if the country went bankrupt.

Public opinion now matters for European policy-making in Germany. That was not always the case. Helmut Kohl ignored the fact that most Germans did not want to give up the Deutschmark for the euro. For him, his neighbours' consent to reunification weighed more heavily than domestic sentiment. Gerhard Schröder did not make a big effort to lessen his voters' fears related to eastward enlargement – despite the fact that for every German in favour of enlargement in early 2004, there were two against. Four EU countries held referendums on the EU's constitutional treaty (and a couple of others had planned to). Germany did not contemplate a referendum, although some leading German policy-makers and commentators called for one.

The Germans have realised that EU policy is not foreign policy – it has profound domestic implications, for local business, for civil liberties and now perhaps for the national budget. They want to have a say. German politicians are no longer able to ignore public opinion on Europe.

Angela Merkel's political style

These underlying changes will influence the EU policies of any German government. Even if Helmut Kohl was in charge in Berlin today, he would act differently from the way he did in the 1990s. The days when Germany could easily act in the 'European interest', pay for EU compromises or ignore its own voters are over. Nevertheless, the style of Angela Merkel, and her domestic political concerns, have shaped Berlin's policies towards the EU during the economic and financial crisis.

When she first became chancellor, Merkel pursued Germany's more traditional role of a broker in Europe. She forged deals on the EU budget and climate change targets. She used her EU presidency in 2007 to get an agreement on what became the Lisbon treaty. Since then, she has shown little vision for Europe. Her EU policies are all about pragmatism and problem solving.

Merkel and her government still instinctively prefer to find European solutions to any problem that arises. But the absence of obvious allies makes EU solutions much harder in practice. Merkel is disappointed with Commission President José Manuel Barroso and mistrustful of France's President Sarkozy. She views Britain as semi-detached from Europe and – despite her earlier protestations to the contrary – does not take smaller EU countries terribly seriously.

Germany has traditionally been a staunch supporter of the European Commission. That support had waned a little since Jacques Delors was in charge in Brussels. But the way the Merkel government has sought to sideline the European Commission is new. When Merkel looks for a compromise on an EU question, she often phones other capitals directly rather than going through Brussels. German government representatives have few good things to say about Commission President Barroso: they accuse him of having moved away from ardent free-market liberalism to French-style industrial activism in his frantic bid to be re-appointed; they also think that he should focus on core EU business, rather than dreaming up new initiatives to impress the European Parliament. Berlin made sure that it was Herman van Rompuy, the Council President, who was put in charge of the new group to devise eurozone reforms, not Barroso. And Germany's proposal for that working group sought to transfer responsibility for monitoring EU countries' fiscal policies from the Commission to the ECB or a new independent body.

Although Merkel may speak to Paris more frequently than Brussels, the Franco-German alliance is anything but strong. Merkel and Sarkozy have learnt that they can achieve little if they work against each other. They are also aware that their positions are often at the opposite end of the policy spectrum, especially when it comes to European economic management. So they think that to achieve a European consensus, they need to agree between themselves first. That does not mean that they share a common vision or even trust each other. Merkel used to get upset about Sarkozy's unilateral initiatives, such as the Mediterranean Union or the idea of a European bank bail-out fund. Now Germany is itself becoming unilateralist: after Berlin announced its national ban on the naked short-selling of German bank stocks and eurozone bonds in May, France protested that it had not been consulted and initially said that it would not follow suit.

A clash in political style further accentuates the rift between Germany and its European partners. Merkel learnt from her erstwhile mentor, Helmut Kohl, that the secret to political longevity is to sit tight and wait for problems to go away. If an issue refuses to die down, Merkel tends to approach it with cautious, cold analysis. She starts from the final objective and focuses on feasible solutions. The chancellor likes to under-promise and over-deliver. At home in Germany, this approach made her consistently popular with voters, at least until recently.

At the EU level, however, Merkel's cautious approach has contrasted with that of Sarkozy and, until recently, Gordon Brown. These leaders have often set ambitious objectives –whether it is cutting carbon emissions by 80 per cent, saving global finance or creating 'purchasing power' for the people – without ever quite figuring out how to get there.

The media has usually zoomed in on the initial disagreement between Merkel and other European leaders. By the time these leaders had worked out a compromise – as they almost invariably did – media attention had moved on and the impression of a lasting rift lingered. German policy-makers are annoyed about this. They point out that despite Merkel's initial caution, Germany enacted a big stimulus programme, did its bit to save Europe's banks and has now made its contribution to the rescue packages for Greece and the other eurozone countries. Yet Merkel's reputation remains that of 'Madame Non'.

Domestic pressures

Although Angela Merkel appears to be the pivotal political leader on the European stage, she is becoming weaker at home. Commentators agree that the Greek bail-out was one of the main reasons why Merkel's CDU did so badly in the May elections in North Rhine Westphalia, Germany's most populous state. They do not agree whether it was her decision to commit taxpayers' money to propping up other eurozone countries that made her unpopular, or her prevarications and lack of leadership.

At the national level, relations between Merkel's CDU and her coalition partners, the liberal FDP and the conservative CSU, were under strain even before the eurozone crisis. They now sometimes look dysfunctional. Guido Westerwelle, FDP head and foreign minister, has been sidelined. The most important foreign policy decisions have always been taken in the chancellery rather than the foreign ministry. But Westerwelle's stronger predecessors, from Hans-Dietrich Genscher to Joschka Fischer, usually acted as the 'European voice' in German foreign policy making. That voice is now missing and the Merkel government appears more willing to go it alone in the EU.

Merkel's domestic political woes have been compounded by the impression that potential allies are deserting her because she relies too much on a small coterie of political friends. In May, Germany was shocked by the surprise resignations of Roland Koch, minister-president of the state of Hesse and deputy head of the CDU, and Horst Köhler, the country's widely respected president. The fact that Merkel failed to get her preferred candidate nominated for Köhler's succession, and her shilly-shallying on important domestic issues, have fuelled the impression that she is no longer in charge.

Her populist short-term reaction to the eurozone crisis is a further sign of political weakness. Knowing that she could not sell the two eurozone bail-out packages to her parliament and voters in the name of European solidarity, she decided to portray the euro crisis as a battle of financial markets against governments. 'Speculators' are even less popular in Germany than profligate South European governments. Hence the ill-thought out and ineffective unilateral ban on naked short-selling and the urgency with which the German government has pushed for an international banking levy, a tax on financial transactions and tougher rules on hedge funds and other investment vehicles.

Some damage limitation is needed

Germany's EU partners need to be aware that the days when the country would equate its national interest with that of the EU are gone for good. Since Berlin has limited experience with international leadership, and sometimes struggles to define its 'national interest', its EU policies may be inconsistent and confusing from time to time. They will invariably be more hard-nosed and more directed at domestic consumption than was the case in the past. Merkel's European counterparts should show some understanding of the chancellor's domestic constraints and acknowledge her efforts that have now made two huge bail-out packages possible. They should admit that other EU countries do have things to learn from Germany, for example in terms of long-term fiscal management. France needs to concede that European solidarity also requires responsibility on the part of all member-states. Other EU countries, such as Austria, the Netherlands and Finland, should stop hiding behind Germany. They wanted tough conditionality for Greece just as badly but let Merkel do their bidding.

Germany, in turn, needs to show more leadership in putting the eurozone on a sustainable footing. Reforms should not only include tougher surveillance of, and sanctions against, eurozone countries that spend too much. Germany itself may be preventing sustainable solutions to the eurozone malaise by refusing to talk about its own economy. Berlin should accept stricter economic monitoring of all eurozone countries, including those that are not currently in trouble.

At the political level, Merkel's government could perhaps do more to revive the Franco-German partnership, which is so essential for the functioning of the European Union. Germany should also remember that a strong and respected European Commission is needed to fend for Germany's own long-term interest, such as a well-functioning single market.

Perhaps most importantly, Germany's leaders need to make a bigger effort to shape domestic public opinion on Europe rather than react to it. For the Berlin government today, being a 'good European' does not necessarily mean agreeing easily to EU compromises. But it does mean convincing the German people that these compromises are necessary and in Germany's national interest.

Many people argue that Germany is becoming a 'normal' country in the EU, and that is just fine. No-one would expect Britain, France or Poland to put European interests ahead of national interests. However, it was exactly because Germany did not always behave like the UK and France that European integration moved forward and European solutions were possible. The risk is that the eurozone crisis is bringing a latent sense of frustration and disillusionment with the EU to the boil. With the German media in frenzy and Merkel's government weakened, German euroscepticism may now take hold. Even if the euro crisis can be contained, it is difficult to see how the EU could make progress on anything – whether it is services market liberalisation or a common energy policy – with a reluctant, grumpy and inward-looking Germany at its heart.

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