CENTRE FOR EUROPEAN REFORM
briefing note

Why Berlin won't back down on euro reform

By Katinka Barysch

★ European politicians and central bankers have criticised Germany for wanting to construct a eurozone insolvency procedure at a time of crisis. Investors are so spooked by possible losses that they have driven Irish and Portuguese borrowing costs to record levels. Yet Berlin is unlikely to back down.

★ The Germans fear that a simple extension of the current, ad-hoc bail-out funds would fall foul of Germany's constitutional court. They predict that setting up a permanent rescue fund without the option of insolvency would encourage reckless government borrowing and thoughtless investment decisions. They argue that preparations for the new mechanism must start now if it is to be up and running by 2013, when the current bail-out funds expire.

★ The debate about the new rescue and restructuring mechanism will be technically complex and politically divisive. The required treaty changes may not happen in time. Yet the other Europeans will have few options but to follow German leadership on eurozone reform.

On October 18th, Angela Merkel and Nicolas Sarkozy stunned their European partners – and most of their officials at home – by announcing the broad outlines of a deal on eurozone reform during a summit with Russia in the French resort of Deauville. Germany seemingly caved in on demands for automatic sanctions to be added to the 'stability and growth pact', the EU's fiscal rule book.[1] In turn, France agreed to back the German plan for a limited change of the EU treaty to set up a permanent 'crisis management mechanism'.[2] This mechanism, said Merkel and Sarkozy, should include provisions for an "adequate participation of private creditors".[3] In plain English: future rescue packages might involve a write-down of existing debt. Ten days later, a summit of EU leaders made the idea official EU policy. The plan has caused political consternation and market panic.

[1] German officials deny that Merkel made concessions in this respect. They say that Berlin realised as early as September 2010 that a majority of EU countries would oppose automatic sanctions.

[2] Charles Grant, 'Europe dances to Germany's tune', CER insight, November 3rd 2010.

[3] Statement for the France-Germany-Russia summit', Deauville, October 18th 2010.

Even before the Deauville deal, bond holders were well aware of the possibility that a struggling eurozone government may not be fully bailed out. Since early autumn, the 'spreads' (the difference between the borrowing costs of Germany and other countries) on Greek, Irish and Portuguese bonds had suggested that investors thought a default quite likely. But since Deauville, these spreads have widened dramatically, to the point where Ireland was driven towards the eurozone's existing rescue fund, the €440 billion European Financial Stability Facility (EFSF) that was cobbled together in May.[4]

[4] Greece already relies on a separate €110 billion rescue package.

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Merkel under fire

Politicians and economists across Europe have criticised the German initiative and implored Merkel to rethink. ECB officials have long warned against the idea of setting up an insolvency procedure at a time when markets are so nervous. In October, ECB President Jean-Claude Trichet predicted that raising the spectre of private bond holders sharing the costs of a bail-out would push up borrowing costs and so make a bail-out more likely. George Papandreou, the Greek premier, reiterated this warning in November, arguing that Germany's insistence on an insolvency mechanism could drive some eurozone countries into bankruptcy. The *Financial Times* reported "increasing accusations that Ms Merkel has put many of her fellow eurozone leaders in untenable positions to reinforce her own standing with German taxpayers".[5] Merkel also faced disapproval at home: German commentators contended that the insolvency procedure was the wrong cure at the wrong time and that Merkel's policy of "savings and punishment" would only make the crisis worse.[6]

Economists and policy-makers have been calling on the German government to drop the plan and instead prolong the life of the EFSF beyond its 2013 expiry date.[7] Merkel has consistently said no to this. She has several powerful legal and political reasons to stick to her position.

[5] *Peter Spiegel, 'Anger at Germany boils over', Financial Times, November 16th 2010.*

[6] *Thomas Fricke, 'In den Knast ihr Schuldner!', Financial Times Deutschland, November 19th 2010; Gabor Steingart, 'Versailles ohne Krieg', Handelsblatt, November 19th 2010.*

[7] *Paul de Grauwe, 'A mechanism of self-destruction of the eurozone', CEPS commentary, November 9th 2010; Simon Tilford, 'Eurozone policy-makers are playing with fire', CER insight, November 15th 2010.*

The spectre of Karlsruhe

Germany's powerful constitutional court in Karlsruhe is still examining whether the EFSF is compatible with the German constitution and with EU law. Lawyers in Brussels say that the EFSF (and the Greek rescue package) do not contravene the 'no-bail out' clause of the Lisbon treaty: article 125 says that EU government shall not be liable for each other's debt; if they help each other voluntarily, that's fine. German politicians and the country's constitutional court disagree. They think almost any budgetary assistance from one country to another could contravene current EU rules.

The court is unlikely to declare the EFSF illegal: it can plausibly be portrayed as an emergency measure needed to shore up the euro. But the judges will probably tell the government that it must not stage similar rescues in the future – unless the EU treaty is changed to build a solid legal base for them.

The German finance ministry initially aimed at changing article 125 itself. But it has since shifted its focus to other articles that look easier to amend while using a 'simplified' procedure available only for minor treaty amendments. Lawyers are now pondering changes to article 122 (which allows EU governments to help each other in case of natural disasters or "exceptional occurrences") or article 136 (which allows eurozone members to set up new procedures and mechanisms among themselves to make the euro function better).

Interdependence, moral hazard and financial discipline

Politicians and officials in Berlin play down potential pressure from the court. They insist that there are sound economic reasons why eurozone governance needs "a new pillar" (in the words of one official) in the shape of a permanent rescue and resolution mechanism.

The Germans no longer seem to believe that the stability and growth pact – however well reformed – will be enough to impose discipline on all eurozone members. Even reinforced monitoring might miss bubbles and private borrowing binges that then wreck public finances (as is now the case in Ireland and Spain). Political disagreement among EU leaders may block attempts to punish profligate countries. Sanctions may not bite, or bite too late. Future crises are possible, even likely. If and when they happen, they will be a problem for the eurozone as a whole.

Wolfgang Schäuble, the finance minister, explains that the Europeans could not foresee how far financial integration would go when they wrote the no bail-out clause.[8] Today, contagion spreads quickly from one troubled country to another. German, French, Dutch and Belgian banks sit on billions of euros worth of Greek, Portuguese and Irish debt.

[8] *Speech at the BMW Foundation European Forum in Berlin, November 5th 2010.*

Add the even bigger debt piles of Italy and Spain and it becomes clear that the solvent 'core' eurozone countries have little choice but to help their more highly indebted neighbours in a crisis. The Germans, in other words, have accepted that the Greek bail-out is unlikely to be the last one. Hence their determination to set up a permanent rescue fund.

However, the existence of such a fund could itself encourage fiscal recklessness, a problem economists call moral hazard. Safe in the knowledge that help is available, some politicians may be tempted to promise tax cuts or generous welfare cheques that their national budget cannot afford. Investors would buy that debt, relying on other eurozone governments to bail them out in case the borrowing country can no longer repay them.

That is why the Germans believe that a rescue fund must come with an insolvency procedure. Even the remote risk of a country being unable to service its debt could make investors pay more attention to the sustainability of its public finances. Although current borrowing costs for the likes of Ireland are driven by panic, some differentiation between eurozone countries with sound budgets and those with shaky ones will be welcome in the future.

Making investors pay

Merkel and her coalition government also have compelling political reason for insisting on an insolvency procedure. German officials still shudder at the memory of the tense days in May 2010, when Merkel's government struggled to get the Greek bail-out and the EFSF through the national parliament. The opposition threatened to vote against the rescue and demanded that the government ensure that "speculators" would never again be allowed to benefit from eurozone turbulence. To placate them, Merkel called for an international financial transaction tax and announced a unilateral ban on naked short-selling of certain stocks and bonds. The opposition abstained and the package went through. But Merkel is convinced that she cannot return to the parliament with another bail-out package unless it foresees the possibility that private investors, not only taxpayers, are involved. If there is one thing that it even less popular in Germany today than bailing out profligate South Europeans, it is bailing out private bankers.

2013 is crunch time

Many Europeans may be sympathetic to the German arguments for involving private investors in future bail-outs. But most are nevertheless upset about the timing of the German initiative (as well as the way Merkel is pushing it through without much EU-wide consultation). The European Commission, the ECB and many European officials and politicians had urged the Germans to wait until the EFSF has proven its worth, Greece and the other troubled countries have had some time to restore fiscal stability and markets have calmed down.

But the Germans are in a hurry. First, they hope to forge an agreement on the mechanism while the crisis instils a sense of urgency in their EU colleagues. Second, they want the mechanism in place by the time the EFSF expires in June 2013 – and well before the German parliamentary election in October that year.

The Europeans are planning to use a 'simplified' procedure for the required treaty change that does not involve lengthy conventions or intergovernmental conferences. But even such minor amendments will have to be ratified in all 27 EU countries. If the ratifications go smoothly (a big if), they will still take at least a year.

What is more, national parliaments will not agree to a treaty amendment unless they can fathom what the new rescue and resolution mechanism will look like. In the past, the EU would usually change its treaties first and then set about implementing new policies and institutions. For example, the exact shape of the new 'external action service' is still being haggled over one year after the Lisbon treaty (its legal basis) entered into force. This time, taxpayers' money and national sovereignty are potentially at stake. Parliamentarians will want to know how the new mechanism will work before they agree to create a treaty base for it.

What will the new mechanism look like?

The debate on the details of the new mechanism, however, is only just beginning. The German government, which aims to take the lead in the debate, appears to have settled on only a few basic parameters so far:

★ the new mechanism will rest on an intergovernmental agreement (like the EFSF); it will not create a new EU institution;

★ the International Monetary Fund will be involved in some way;

★ the insolvency procedure will consist of two steps: when a country can no longer service its debt, it gets access to emergency funding guaranteed by other eurozone countries for a few years, to buy time for the government to get its finances under control; only if fiscal consolidation fails will there be negotiations with investors on a debt restructuring;

★ the clauses governing a possible insolvency will be written into the contracts attached to new bond issues; the alternative would have been to pass a law that applies to all existing and new debt.

The most important questions remain wide open: how much money will individual eurozone countries make available? In what way, if at all, will non-euro countries be involved? What will be the role of the European Commission and other EU bodies? Will the new mechanism be available only for 'insolvent' countries or also those that are temporarily frozen out of the bond market? Who can declare a country 'bankrupt'? How will the losses that investors are supposed to swallow be determined? What kind of conditionality will be imposed on the borrower and by whom? The most fundamental question, however, is this: how can the eurozone countries strike the right balance between preventing moral hazard and showing support for struggling neighbours?

There are not an awful lot of precedents that the Europeans could build their mechanism on.[9] And the fact that the nations involved share a common currency and are ruled by complex EU treaties complicates things further.

[9] *See the excellent overview in: François Gianviti, Anne Krueger, Jean Pisani-Ferry, André Sapir, Jürgen von Hagen, 'A European mechanism for sovereign debt crisis resolution: A proposal', Bruegel, November 2010.*

High-risk strategy

The German plan for setting up a crisis management mechanism in the middle of a crisis is a risky one. EU leaders may fail to agree on the outlines of a resolution mechanism. A spiralling debt crisis in Ireland, Portugal or Spain, or social unrest in Greece, may divert EU policy-makers attention. A restive EU country may add its own demands to the debate on treaty change, thus frustrating German attempts to keep the changes to a minimum. Even if treaty amendments can be agreed quickly, national parliaments or eurosceptic heads of state could foil the ratification process.

Some of Germany's neighbours say that Merkel should have focused on strengthening EU fiscal rules and sanctions instead of starting the ambitious construction of a new pillar for the eurozone now. Many in Southern Europe accuse the Germans of being selfish and lacking solidarity. The German leadership is unlikely to be moved. For the reasons laid out in this briefing note, Germans are convinced that their strategy is the right one. They believe that Germany alone has the economic muscle and the political determination to lead the eurozone out of the crisis. "We are begging our neighbours to help us build a mechanism so we can help them," sighs one German official. But then he adds: "If the other euro countries want to set up their own rescue fund without us, that's fine by us too."

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