Germany: Divided by a common currency

The German government is standing firm on austerity measures to overcome the Eurozone debt crisis. But how flexible is Angela Merkel? And what is the price of failure?

Summertime brings out the best in Berliners – people smile more, they're friendlier, and they're generally more upbeat about life. The sidewalk cafes roar with laughter. But behind the crowded street cafes this year is a lingering angst that this might not last. Newsstand headlines point to the country's growing commitment to the European Financial Stability Facility (EFSF) – now at 27 percent of a targeted €780 billion - and the rapidly falling value of the euro which, for many Germans, is the third or even fourth currency they've held in their lives.

Leading German economists don't believe Chancellor Merkel can politically afford to back peddle much on the Fiscal Compact, introduced in March 2012, which requires EU signatories to introduce national legislation to balance their budgets.

Merkel was forced to grant concessions to ensure passage of the Fiscal Compact. The opposition Social Democrat Party (SPD) – succeeded in attaching supplementary measures, including an EU-wide financial transaction tax and a stimulus package worth up to €60 billion. The SPD lobbied hard at home and have drawn support from the new French president François Hollande, who is calling for less austerity and more economic stimulus to generate higher tax revenue.

No new debt

The overriding question now is how much EU stimulus – and therefore new debt and higher expenditures – Merkel is willing to accept without enraging the German taxpayer. "I would expect her to stay firm on this, because she has built this up as a principled position," chief economist of Deutsche Bank, Dr. Thomas Mayer, told INSEAD Knowledge ahead of the vote on the Fiscal Compact in German parliament. "So she cannot easily move away from that position without being challenged by her political opponents."

Mayer believes that Merkel will also remain opposed to proposals for a Eurobond, which would pool sovereign bond issuance throughout the Eurozone and allow member states to share investor capital as well as interest costs. Several EU leaders suggest writing Eurobonds into the Fiscal Compact. But Merkel views this as a "mutualisation of debt", a move that would transfer capital to Eurozone countries that spend freely. "They are a bad idea because as long as we are not a political union, we cannot mutualise debt," says Mayer. "If you would have the German taxpayer pay for the decisions that are taken by other sovereign parliaments, it will not work. It would be a violation of basic principles of democracy, and therefore it will lead to the breakdown of the EMU (European Monetary

Union)."

Full EU Integration

To address this problem, Merkel suggested in mid-June, a closer political union whereby countries would decide more national issues as an EU group. This is a step up from earlier talk of a fiscal union yet has a different meaning, according to Mayer, in different countries. "Some countries think of this as a 'euro event' and lots of transfers from strong countries to weak countries. Others see it as a regulatory system for your budgetary decisions. I think neither will work." Mayer is sceptical about Merkel's Fiscal Compact and indicates countries will ultimately do what is in their own sovereign interests.

Mayer and many other German economists believe the healthiest remedy is to allow the markets to decide: "So what I think we need to do is go back to the basic principles – sovereign countries are responsible for their sovereign decisions and liable for their sovereign decisions. So countries must go bankrupt, must get a debt restructuring like Greece did, in case they can no longer pay."

The German government is currently juggling numerous proposals to remedy the deepening euro crisis, including the Fiscal Compact, a fiscal union, or closer political union, and a banking union – all of them controversial, and none of them immediate. There is widespread support for a banking union – especially an EU-wide deposit insurance programme – but that could take several years to complete. Finance ministers have also discussed a banking oversight commission and resolution regime, which would wind down failed banks.

Hole in the bucket

Germans frequently compare state aid to a water bucket with a hole – it is full when it leaves the drinking well, but arrives at its mark half-empty. With that in mind, Germans prefer stabilising weak banks directly from the EU, International Monetary Fund or European Central Bank. Mayer points out: "In the case of Greece… if we stabilise the Greek banks in the European structure outside the Greek government structure, then we would have a nucleus for such a banking structure, because the banks would be in a European resolution regime and deposits would be safeguarded by the EU or by the euro area authorities."

The immediacy of a deposit insurance scheme cannot be understated – Greeks and Spaniards have been withdrawing money from domestic banks and opening accounts at German or other foreign banks. "It is important that the Greeks do not lose any money held in banks because I think it would be a bad example to other countries to run on their banks," says Mayer.

The euro crisis is galvanising political forces in Germany as parties test public opinion in advance of next year's national elections. The opposition SPD accuses Merkel of delivering too little, too late. Merkel rejects this and points to recent polls showing a majority of Germans concerned about the rising costs of Eurozone bailouts. In a June survey, FORSA/Stern reported 38 percent were somewhat concerned about the costs to Germany, while 22 percent expressed great concern.

Germans fear they might have to surrender some of their hard-earned prosperity to help other Europeans who they believe are living beyond their means.

Merkel characterises the old adage "where you stand on an issue, depends on where you sit." Germany earned its prosperity by remaining competitive. It also stands to lose a great deal if the euro fails. Leading German economists say the greatest challenge is to restore market confidence in the euro. "What you need is a programme of debt reduction in these states that are suffering from over-indebtedness, and you also need structural reform," argues Mayer. "Because that is essential to kick-start growth. So, measured fiscal adjustment and structural reform, I think, is the way to restore confidence and then growth will come back."

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