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Waiting for Merkron: The Franco-German Relationship and Eurozone Reform after the Elections

Henning Deters and Magnus G. Schoeller

Executive Summary

> France and Germany have fundamentally different interests concerning the Eurozone. Contrary to prevailing sentiment, the recent elections in both countries will therefore not necessarily reignite the Franco-German motor to bring about the pending Eurozone reform.

> Although Merkel did not refuse Macron's recent Euro reform plans, the ostensible agreement is owed to the fact that both sides mean different things when referring to an EU Finance Minister or a fiscal capacity to stabilize Eurozone economies.

> Disagreement extends to strengthening the Eurozone's social dimension and the revived idea of a European unemployment protection scheme. By contrast, France and Germany agree on protecting their labour markets.

> Macron frames problems in innovative ways and exhibits a cooperative style. Despite differences, a renewed tandem may therefore be able to reform the Eurozone if certain conditions are met: External drivers, such as, the 'refugee crisis' and security concerns may facilitate cross-sectoral package deals; at the EU level, a rekindling of the Euro crisis could increase pressure on the tandem to make concessions; domestically, reform may be required as a continued 'muddling through' could further strengthen right-wing populists.

> Not in the least, any Franco-German *entente* will need to respect the preferences of other member states, promote the Eurozone's social dimension, and strengthen its democratic legitimation.

The Eurozone crisis is not overcome yet. It may be suspended, mainly due to European Central Bank President Draghi's announcement 'to do whatever it takes to preserve the euro', but the underlying design failures are far from fixed. Thus, a bank insolvency in a Eurozone member state or disagreement about the next credit tranche for Greece may be enough to reignite the crisis. To rule out fragmentation, the Eurozone must be further reformed. Leading economists from France and Germany have recently emphasized that this reform strongly depends on a Franco-German compromise (Véron *et al.* 2017). Indeed, the Franco-German 'tandem' has always been a motor for European integration, especially regarding the common currency. This role is not self-evident, however. While their intense cooperation during the Euro crisis earned French President Sarkozy and German Chancellor Merkel the label 'Merkozy' (Schild 2013), cooperation cooled down under President Hollande, and the Eurozone reform stalled. Since the election of Emmanuel Macron as French President, we can observe a new wave of optimism when it comes to the Franco-German tandem. In this policy brief, we therefore assess the likelihood of 'Merkron': *under which conditions can there be a revival of the tandem in the Eurozone?*

Previous research tells us that the Franco-German motor is most successful if the preferences of the two governments diverge (Webber 1999). In such a case they have to find a compromise that also embraces other member states' preferences. This explains why, when a Franco-German compromise exists, the Council often adopts it largely unchanged. By contrast, if the positions of France and Germany are too close, the tandem has no traction. Fearing to be marginalized, the remaining governments tend to reject the imposition of such an exclusive accord. Besides a tandem with or without traction, a third possibility is to have no tandem at all. This is the case when the preferences of France and Germany are simply too diverse to be reconciled, in spite of the unique institutionalization of Franco-German cooperation.

In short, for a strong tandem to emerge, the French and German preferences must hit the 'sweet spot' between conflict and *cliquism*. In order to assess the chances for a revival of the Franco-German partnership in the reform of the Eurozone, we first analyse the two countries' respective preferences on key issues. Second, we identify the conditions under which 'Merkron' is likely to occur. In contrast to the prevailing sentiment, we argue that the chances of a Franco-German tandem to bring about the needed reform are tightly constrained by differences that are hard to reconcile. However, changes in the international security environment, a rekindling of the Euro crisis, and the populist challenge at home may make the twin-engine restart.

Issues and preferences in Eurozone reform

One of the most pressing reform issues in the Eurozone is the **completion of the Banking Union**. However, instead of taking the lead on this issue, the Franco-German tandem has come to a deadlock. The Banking Union is supposed to break the vicious circle (or 'doom loop') between sovereigns and banks in the Eurozone: if big banks get into trouble, their national governments bail them out, as they are considered too big to fail. This raises public debt and thus worsens the creditworthiness of the state. As banks hold sovereign bonds of their states, a lower creditworthiness reduces the value of these bonds in the banks' balance sheets. This, in turn, may require (further) bailouts, and so on. Therefore, the EU has already adopted a common banking supervision and a bank resolution mechanism. However, it still lacks a common deposit insurance and a fiscal backstop to stabilize the financial system in case of a bank resolution. Regarding the latter, a single resolution fund will be built until 2024, but even then its capacity will remain limited. The German government insists on further steps to minimize risks at the national level before mutualizing them at the European level. The French government, by contrast, points to the fact that these risks only exist because the Banking Union is still incomplete. Therefore, it prefers to go on with the common deposit insurance and the fiscal backstop.

A possible compromise to break this deadlock would be European Safe Bonds (ESBies): these are senior securities which are backed by a diversified portfolio of sovereign bonds. As they would allow banks to diversify their balance sheets, while highly indebted states would have to pay lower risk premiums on their bonds, they could be an instrument to break the doom loop between banks and states. However, although ESBies would not imply any joint liability, the German government is not enthusiastic about the idea. The main reason for the German scepticism is that ESBies would reduce market pressure on Eurozone states, which in turn may create moral hazard and reduce fiscal discipline.

While the deadlock regarding the completion of the Banking Union has remained unresolved so far, the **Eurozone Finance Minister** has moved to centre stage since Macron's election. Both governments support the idea, but there is reason to assume that they mean different things when they talk about a common Finance Minister. While the German government primarily refers to a European budget supervisor who enforces fiscal rules and sanctions, the French government thinks of a minister who can (also) decide about transfers to combat regional shocks or even recessions. Further competences, which could become part of a larger package deal, are the right to chair the negotiations of the Eurogroup and to represent the Eurozone internationally. In any case, a Eurozone Finance Minister would need his own budget, that is, fiscal capacity (Enderlein & Haas 2015).

As opposed to Eurobonds, i.e. the issuance of common debt, a **fiscal capacity** has not been excluded by Germany. Chancellor Merkel is open to the idea 'if used for sensible ends'. Thus, while a comprehensive Eurozone budget as preferred by President Macron seems unrealistic for the time being, a small budget to help Eurozone members implement economic reforms, fight youth unemployment, or boost labour mobility is quite possible. More ambitious would be a 'rainy day fund', as recently brought up by the European Commission and the Director of the European Stability Mechanism (ESM), Klaus Regling. Such a fund would serve to fight economic shocks in single member states (European Commission 2017). However, a European

Monetary Fund could also fulfil this function: based on the existing ESM, this European version of the International Monetary Fund would allow member states to use common funds for fighting recessions. Both outgoing German Finance Minister Schäuble and Chancellor Merkel have expressed their support for the idea, if the new institution obtains more control over national budgets. Critics of the idea have therefore argued that a European Monetary Fund would primarily serve Germany as a powerful instrument to apply austerity in the Eurozone. Whether this is true will also depend on how the Fund is financed: while Germany wants to restrict funding to member states' contributions, and thus maintain full control over the institution, France prefers the Fund to raise own resources. This would correspond to the mutualisation of debt.

Finally, the question of democratic legitimization remains: how can a European Finance Minister or Monetary Fund be held to account? The French government under Macron has proposed a **Eurozone Parliament** with the powers to pass an own Eurozone budget and to control the ESM and a future Finance Minister. This assembly could consist of national parliamentarians or Members of the European Parliament, or both. Germany, however, is very reluctant when it comes to ceding control over the money it provides to other Eurozone members. Moreover, it shies away from the treaty changes this would require. Instead of a real Eurozone Parliament, a non-permanent committee with purely consultative powers therefore seems to be the best deal achievable for the time being.

Although the preferences of France and Germany diverge in many respects, a combination of a Finance Minister, a fiscal capacity, and a certain degree of parliamentary control could form a larger package deal between the two countries. However, any such deal would need to be an exchange between solidarity and control. In other words, Germany will accommodate French solidarity-related preferences only if this will be linked to an enhanced control over national budgets.

Both Macron's *'Europe de la croissance'* and the Commission's 'pillar of social rights' argue that the Eurozone needs a stronger social dimension. Macron's platform suggested upward harmonization of **unemployment protection** as one way to implement the above-mentioned fiscal capacity. Yet chances are slim that a Franco-German tandem will push the issue forward, as Germany is stepping on the brakes. Its council of economic advisers cautioned that a common unemployment scheme was yet another step toward dreaded *Transferunion*. The German position entails the belief that only internal devaluation, that is, downward adjustment of wages and social benefits, creates jobs in the Euro periphery and that market pressure is the most efficient way to encourage corresponding 'structural reforms'. An insurance scheme would only remove this pressure and create moral hazard. These fears are widely shared among the German Christian Democrats. On various occasions, outgoing Finance Minister Schäuble dismissed Macron's plans as unrealistic, suggesting they required arduous treaty reforms. There is no reason to expect more support from any new Finance Minister in the possible future 'Jamaica' coalition (Christian Democrats (CDU/CSU), Liberals (FDP), Greens), especially if he or she is from the FDP, which at this point seems the most likely scenario. Moreover, the presumably reluctant Finnish and Dutch stances would pose a challenge. Nonetheless, if France and Germany were to bridge their differences, a moderate proposal could fall on fertile ground. Spain and Italy already outlined far-ranging visions for a European insurance scheme, and parts of Central and Eastern Europe (CEE) have also expressed support. So far, however, Merkel sided with Schäuble. All things considered, there is thus little room for Franco-German agreement on a European unemployment insurance scheme. More likely is a further extension of European funding for the 'Youth Guarantee'.

There is much more Franco-German accord on reforming the single **European labour market regime**, but a successful tandem must carefully navigate the demands of the CEE member states. Mundell's theory of optimum currency area identifies labour mobility as precondition for common currencies, allowing workers from countries hit by an asymmetric shock to find (temporary) employment abroad. Adjustment via migration, including posted work, partly compensates for the loss of control over the foreign exchange rate. Under the current rules, posted workers are subject to what is called the 'hard core' of the host-country provisions, including minimum salaries. Beyond this, posted workers may be treated differently according to origin. The reform has been deadlocked for many years due to contrary interests of the high-wage net

recipients such as France and Germany and the low-wage net senders of posted workers, such as Poland and Romania. Macron wants to push ahead, but having promised French workers protection against globalization, he is hardly a neutral arbiter. On posted workers, France and Germany are on the same page. Both are among the EU countries with the highest wages, and both are net receivers of posted workers. With Belgium, they receive half of all postings. Rather than facilitate free movement of labour as potential buffer against asymmetric shocks, their prime motivation is to protect their national autonomy over employment regulation and their competitive position. Their reform proposal centres on enlarging the hard core, according to the principle 'same pay for the same work in the same place', a commitment to which other high-wage countries signed up, too. The Maltese Council Presidency had hoped to conclude the negotiations in June 2017, but Macron unravelled the compromise package in search of a more favourable deal that further limits the duration of postings and includes transiting road haulers.
After Macron's election, France and Germany worked intensely towards aligning their positions before entering into negotiations with the whole Council. A Franco-German ministerial council in July 2017 reaffirmed the original demands. The tandem is running, but rather than driving integration forward, it is set on a collision course. Its interventions have produced logjam. The negotiations 'will be delayed', the French President admitted in a speech in May, 'so that we can truly reform'. Franco-German cooperation is unlikely to change the fact that the CEE states are not going to accept a bigger hard core and a shorter posting duration. Since a qualified majority is necessary to adopt the reform, deadlock is likely to remain (Voss 2016).

Macron is well aware of the German insistence on a *quid pro quo* between solidarity and control. His ambitious Eurozone reform agenda cannot be realized without Germany and is therefore strongly linked to a **domestic liberalization agenda** that accommodates Berlin. 'If we don't implement ambitious structural reforms, the Germans won't follow us', the President observed in May. Already the *Loi Macron*, adopted under Hollande, came about when Brussels and Berlin tightened the screws over the French budget deficit. The current labour market reform continues where the *Loi Macron* left off. Employment protections are to be loosened, more issues in collective bargaining devolved to the company level, red tape and public sector employment cut back, and the business tax lowered. When faced with the choice between delivering on promised tax cuts and complying with the *Schuldenbremse*, Macron opted for the latter.

In sum, the French and German visions for the Eurozone's badly needed reform are hard to reconcile. Where France sees powerful shock absorbing capacities and solidarity, Germany sees moral hazard and insists on national responsibility. On some issues both governments seem to agree superficially, but once it comes to the nitty-gritty, for example regarding a European Finance Minister's concrete tasks, the conflict that looms behind ambiguous labels becomes manifest. Only when it comes to protecting national labour markets, France and Germany are truly on the same page, but against headwind from CEE countries, the tandem cannot gain much traction.

A way out of the deadlock?

Our analysis shows that neither the issues on the table nor the preferences of the two countries have changed significantly with the election of Macron as President. Moreover, since Germany is the more powerful partner in this relationship (and, as a creditor state, closer to the *status quo*), one may argue that in order to set the tandem in motion, a change in the Élysée Palace is of little help as long as the Christian Democrats lead the German government. If, moreover, the Liberal Party supplies the next Finance Minister, the tandem will be even more constrained. Why, therefore, should there be any optimism regarding the future of the Franco-German tandem and its effect on the urging Eurozone reform?

We argue that the election of Emmanuel Macron is a chance for taking up Eurozone reform. First, Macron abandoned certain labels such as 'Eurobonds' that set off alarm bells in Berlin. Second, he adopted a more temperate political communication than his predecessor, both in style and content. This is especially important with regard to German voters. Whereas Hollande came into office as the Socialist who wanted to backtrack on the Fiscal Compact – a European version of the German *Schuldenbremse* – and mutualize public debt, Macron comes across as a pro-European reformer. His demonstrated willingness to implement structural reforms at home signals credible commitment to German voters. Macron also refrains from demanding any institutional change that would be all too clearly to the alleged disadvantage of the German taxpayer. By contrast, ideas like a Eurozone Finance Minister or a Eurozone Parliament seem to promise enhanced control and legitimacy rather than fiscal profligacy and common debt.

However, while this may do away with key concerns of German voters, it still does not solve the problem of distributional conflicts and diverging preferences at the European level: new labels alone do not enable win-win solutions. Moreover, many of Macron's ideas would require a change of the EU treaties, which is considered infeasible for the time being. Macron's election may therefore just be a necessary condition for a revival of the Franco-German tandem – it is not sufficient for bringing about institutional change. In order for the latter to succeed, the two governments must either be pushed by an ever less tenable *status quo*, or be pulled by new benefits appearing on the horizon. Both push- and pull-factors can emerge from events at the international, European or domestic level.

First, **international events** may increase the costs of the *status quo* or enable new benefits in several policy areas. This enhances the attractiveness of cross-sectoral deals between France and Germany. For instance, the current 'refugee crisis' brings Germany in the position of a *demandeur* because France is in less need of a common asylum system (and its preferences thereby closer to the status quo). In the Eurozone crisis, the situation is inverse: France suffers higher costs and is therefore more interested in a common solution. Hence, linking the refugee crisis to the Eurozone crisis could enable new deals, as Germany might accommodate French preferences on economic governance in exchange for its support in reforming the EU's migration policy. An example of new benefits appearing on the horizon is Brexit. The UK's exit not only requires treaty change, which member states have so far avoided, but also renders an agreement on treaty negotiations and legislation more likely, as with the UK an important veto player is leaving the EU. For example, reforms of the European labour market have stalled not in the least due to the UK. With regard to the international security environment, finally, Germany may become more dependent on France, as Russia pursues an increasingly assertive foreign and security policy, and as the USA under President Trump are less reliable as a partner. Indeed, Chancellor Merkel has already made explicit that the era in which Europe could fully rely on others is over and that it therefore must take its fate in its own hands. This may not only re-establish the 'balance of imbalances' between German economic power and French military power, but also enable cross-sectoral agreements in economic governance and security cooperation.

Second, **events in the Eurozone** may increase the *status quo* costs for Germany or France and thus enhance the functional pressure to agree on further steps of Eurozone reform. If, for instance, major Italian banks get into trouble or no agreement on the next ESM tranche for Greece can be reached, the entire Eurozone may find itself again on the verge of an existential crisis. This would force Germany and France to agree on further reform steps, as the collapse of the Eurozone is much more costly than single concessions needed for a new compromise. Still, any intra-sectoral deal between the two countries will be based on the formula 'more solidarity only in exchange for more control'.

Finally, **domestic events** can alter the costs and benefits of the Franco-German cooperation. Until now, the German government has been constrained by the run-up to the federal elections in September. It is well-known that pre-election periods do not leave much room for difficult decisions. The right-wing populists of the *Front National* and *Alternative für Deutschland* would (mis)use each pro-European decision to obtain votes at the cost of the governing parties. With Le Pen for now defeated and the German election contest over, the new German and French governments will have more leeway in making pro-European arrangements. However, both Macron and Merkel remain challenged by populist parties. They know that kicking the can down the road would only favour populists and signal their governments' inability to act. Ironically, the populist challenge may thus encourage the tandem to close ranks and accept mutual concessions in Eurozone reform. At the same time, however, much depends on the ongoing coalition-formation in Germany. If the FDP, which regards solidarity as a cause of moral hazard, supplies the Finance Minister, the room for concessions will not expand but even shrink.

Conclusion

Although our analysis of French and German preferences regarding Eurozone reform does not allow us to share the current media enthusiasm, we consider a revival of the tandem to be an indispensable condition for the pending completion of the Economic and Monetary Union. We therefore highlight factors that may enable a revival of the Franco-German motor in spite of deep and persistent differences. Crisis events on the international level or in the Eurozone may increase the cost of 'muddling through' to an extent that makes painful Franco-German compromises more attractive. On the domestic level, the end of two consecutive election campaigns heralds a return to *Sachpolitik*, while the ongoing populist challenge may well encourage a common line. Even if the Franco-German tandem can agree on further reform steps, fundamental distributive issues will remain (creditor vs. debtor states; solidarity vs. austerity etc.). Therefore, any deal between the two countries will be based on the formula solidarity *vs.* control: Germany will only agree to more burden-sharing in the Eurozone if this is tied to more control over national budgets. Moreover, technocratic solutions such as a Eurozone Finance Minister do not necessarily improve the life of the people in crisis-ridden member states. Thus, the tandem will not only have to enhance burden-sharing and control in the Eurozone, but will also need to bring forward the Eurozone's social dimension. A European unemployment scheme, for example, could be a first step in this direction. Next to building up a social pillar of the Economic and Monetary Union, the Franco-German motor will, finally, have to pay attention to the democratic legitimacy of its actions. On the one hand, this concerns the process of Eurozone reform: while it is important to take the lead by setting the agenda, compensating potential losers, and leading by example, the preferences of other member states need to be taken into account. On the other hand, the outcomes of Franco-German leadership must be legitimized. The best way of doing so is by tying institutional innovations at the European level – such as a Finance Minister or a European Monetary Fund – to the oversight of the European Parliament.

Further Reading

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About the Authors

Henning Deters is Assistant Professor at the Institute for European Integration Research (EIF) at the University of Vienna.

Magnus G. Schoeller is postdoctoral researcher at the Institute for European Integration Research (EIF) at the University of Vienna.