
VIEW: WINDOW OF OPPORTUNITY FOR EU REFORMS HAS ALREADY CLOSED

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An abiding truth in the United States is that all politics is local. Apparently, the same wisdom can be applied (to some extent) to the European Union, whose agenda ultimately depends on key member states national politics.

This is particularly true with respect to eurozone institutions, which almost everyone agrees are in urgent need of reform. Indeed, shoring up the eurozone was the common thread in major speeches by European Commission President Jean-Claude Juncker and French President Emmanuel Macron last month.

In his State of the Union address, Juncker boldly outlined his ambitious vision for Europes future. He called on the EU to complete its banking union, establish a European finance ministry (fully integrated into the Commission), and expand the EU-level budget.

Macron, in a speech at the Sorbonne, touched on issues ranging from defense and security to eurozone reform and Europes political divides. But he left much unsaid. And, in line with his role as a national leader, his was an inter-governmental, not a community perspective.

Still, both speeches were clearly intended to frame the political debate now underway in Germany, where Chancellor Angela Merkels Christian Democratic Union (CDU) is trying to form a new coalition government. Many observers had hoped that Germanys recent federal election would open a window of opportunity for EU-level reforms. But it is now starting to look like that window has already closed.

The fate of any EU agenda □ whether Junckers or Macrons □ rests with Merkel, who is unlikely to make any significant political moves. Indeed, bold action of the type Juncker and Macron have proposed would not just be uncharacteristic for Merkel; it would also require her to invest all of her remaining political capital.

Throughout her career, Merkel has always behaved, not unreasonably, as if her main goal was to be reelected. And because the CDU would prefer to dominate a government □ and if possible, govern without coalition partners □ it has always sought to win a majority by appealing to German voters in the middle of the political spectrum.

Merkel has a keen sense of where the middle is, and how and when it might shift. Accordingly, she often adopts her competitors ideas. While in office, she has established a minimum wage, lowered the retirement age to 63 (for those with 45 years of contributions), and legalised same-sex marriage □ policies that are anathema to traditional conservatism, but that now have broad

popular support.

As the American economist Harold Hotelling explained in 1929, those competing for the middle have an undue tendency * to imitate each other. Accordingly, the CDU and its main competitor, the Social Democrats (SPD), have become increasingly indistinguishable. And, as a corollary, smaller parties seeking an electoral foothold have had to target political minorities, many of whom have strongly held preferences and beliefs.

Because the CDU and the SPD lost support in the recent election, with the latter deciding to spend the coming electoral term in the opposition, Merkel will need to form a coalition with such parties. But no mainstream German party, let alone Merkels, would govern with the third-largest faction in the Bundestag, Alternative for Germany (AfD), a far-right anti-EU party that garnered 13% of the vote.

That leaves the Free Democrats (FDP), who are liberal in a European sense, but also frustrated with the eurozones malaise. Giving voice to German transfer fatigue, the FDP is adamantly opposed to any arrangement that transfers German money to underperforming member states.

During the campaign, the FDP thus drew a red line against furnishing the EU with a fiscal capacity, under any guise. Two other FDP proposals – a sovereign-debt-restructuring mechanism, to force creditors to take responsibility for their decisions, and temporary withdrawal from the common currency for over-indebted member states – could further complicate matters for eurozone reformers.

The FDPs ideas have broad support in Germany and among German economists (and are shared by a number of other European economists). And they are consistent with positions taken by the German Ministry of Finance under the previous government. But policies that might work in a perfect world of efficient and resilient financial markets could be dangerous if applied in highly imperfect real-world markets. As we saw a decade ago, financial institutions operating in an environment of uncertainty can become fragile and collapse, imposing high costs on society.

The idea of a temporary exit from the euro is particularly ill-advised. If that option were formalized, markets would price it in, and member states without deep capital markets would pay a premium. Their interest rates would be structurally higher. And under volatile conditions, they are prone to face runs from fickle institutional investors, wary of rolling over their credit lines.

The FDP campaigned on an exit option, and its leaders, having been out of parliament for four years, will not want to risk their credibility by backing away from it now. And besides, some deputies in the CDU, and many in its Bavarian sister party, the Christian Social Union, are sympathetic to the FDPs positions. The third likely member in Merkels new coalition, the Greens, would hardly be able to counterbalance these internal forces.

Another problem is that neither Juncker nor Macron has offered much in the way of detail. The actual design of a future eurozone budget – and the types of expenditure it would include – is still unclear. So, too, is the process for holding a eurozone finance minister accountable and ensuring his or her democratic legitimacy. It is also not evident how much national sovereignty would be lost, in the name of a shared fiscal capacity.

Sorting out these questions will require a level of political entrepreneurship unlike anything Merkel has ever shown. To join in Macrons European project, she would have to assume an entirely new

role and expose herself to substantial political risks. Germany would have to take the initiative: rather than rejecting proposals, it would have to offer its own.

Such behavior can hardly be expected from a government that, beholden to the median German voter, plays it safe. The German political centre has been shifting, and it is heading in a different direction than Juncker and Macron. As a result, the eurozones institutional design will likely remain incomplete.

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