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MEMO TO MERKEL: POST-ELECTION GERMANY AND EURO

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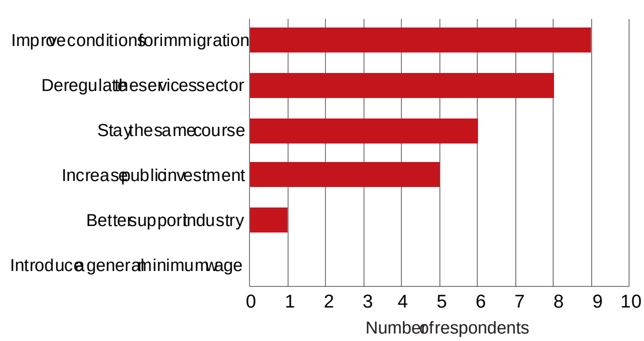
POLICY CHALLENGE

The new German government should work on three priorities: (1) Domes
economic policy should be more supportive of growth and adjustment, w
higher public investment, a greater role for high-value added services, an
more supportive immigration policy. (2) Germany should support a mean-
ingful banking union with a centralised resolution mechanism requiring a
transfer of sovereignty to Europe for all countries including Germany. (3)
The establishment of a private investment initiative combined with a Euro-
pean Youth Education Fund and labour market reforms should be promo



Source: Bruegel-SWP German business survey. See Figure 2.

Building on these prior-
ities, a significant
deepening of the euro
area is needed, with a
genuine transfer of
sovereignty, stronger
institutions and demo-
cratically legitimate
decision-making struc-
tures in areas of
commonpolicies are still nee
ness adjustment is incomple
public debt. Second, bankin
national lines, resulting in un
erode growth, job creation a

4. See Zsolt Darvas, Jean Pisani-Ferry and Guntram Wolff (2013), 'Europe's growth problem (and what to do about it)', *Policy Brief* 2013/03, Bruegel.

5. André Sapir and Guntram Wolff (2013), 'The neglected side of banking union: reshaping Europe's financial system', *Policy Contribution* 2013/13, Bruegel

creditors to the greatest extent possible without undermining financial stability. The second is that fiscal responsibility should in principle reside with those, who have (had) supervisory and broader economic policy responsibility. The third is that common fiscal support is desirable and also in Germany's interest if it can avoid forbearance or fiscal instability in affected countries and further fragmentation of the European financial market.

The precise institutional set-up of the European resolution mechanism is beyond the scope of this Policy Brief. As a guiding principle, it will be important that the mechanism can come to a decision on a bank in resolution in a relatively short period and that national considerations do not play a significant role in the resolution process. The creation of a comditional on the implementation of national labour-market reforms.

GOVERNANCE REFORMS AND ECONOMIC OUTLOOK

By accepting the completion of banking union, the new German government would crucially contribute to stabilising the euro area and preventing a further deterioration of the crisis emanating from the banking sector. A reorientation of German economic policy would help rebalance the currency union and alleviate the profound economic, social and political crisis in some countries. Beyond its expected beneficial economic effect, a private investment initiative with an additional European Youth Education Fund would be a clear signal ahead of the European elections that the unemployment population is not forgotten amid the concerns about calming financial markets.

The combination of these three measures, which could be implemented at short notice, would prepare the political ground for further far-reaching reform of the euro area. Progress needs to be made in three areas: fiscal union including a euro-area budget, the establishment of stronger supranational governance structures, and the democratisation of decision-making for when joint decision-making is necessary at EU level. While none of these areas can be fully covered here, we discuss the objectives of further integration in each area.

Fiscal union has *de facto* been launched by establishing fiscal control and sanctioning mechanisms to avoid negative spill-over effects and by setting up the ESM. The opportunity is now to add further elements that will stabilise the euro area over the long-term and make public finances less vulnerable to violent market reactions. A euro-area budget could incentivise and support structural reforms in countries that respect the commonly-defined reform targets and in which tight budget constraints limit progress on reforms. Second, a euro-area budget could stabilise regionally diverging business cycles without representing a one-way transfer mechanism. While the completion of the single market, in particular to increase cross-border integration of labour and capital markets, would dramatically reduce regional business cycle divergences, a euro-area budget could help absorb very large shocks such as those of the current balance-sheet recession. Germany itself would have benefited from such a system in the early years of the euro area when as the 'sick man of Europe,' it suffered from economic slump and high unemployment while having to implement structural reforms.

•Contrary to the current approach, the sharing of sovereignty should be advanced by a strengthening of European institutions.•

A deepening of fiscal union requires the reform of the institutional set-up as a prerequisite. The principles to be respected when designing the institutional framework should be to increase the democratic legitimacy of decision-making, to minimise moral hazard and free-riding and to complement the assistance approach by strengthening of market discipline. To this end, the euro area should be equipped with a sovereign default mechanism, which needs to be combined with risk weights on sovereign debt for banks. Such a sovereign default mechanism would be credible and would thereby allow market discipline to be reintroduced at an earlier stage when problems build up. In cases of clear insolvency, it would allow those problems to be solved by restructuring instead of relying on the community to pay for the private benefits.

Increasing the legitimacy of the euro area and the EU is a prime task for policymakers in the years to come. The euro area, and with it national decision-makers, have lost legitimacy in two ways. Economic performance and employment is weak in some member states and membership of the euro area is increasingly seen as a problem, rather than a solution. Meanwhile, there is a feeling that national elections and national decision-makers can no longer meaningfully influence the economic, financial and societal course a country takes. In order to stop support for the euro area eroding further, there is a pressing need to increase the legitimacy of the institutional set-up[6].

One conceivable measure would be to strengthen the role of the European Parliament in the economic and fiscal governance of the monetary union by enabling it

6. Daniela Schwarzer and Richard Youngs (2013) 'Crises in the Euro Area and Challenges for the European Union's Democratic Legitimacy', *EuroFuture Paper Series*, German Marshall Fund, May.

to meet in a euro-area formation.