**German Designs for Europe's Economic Future**

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The euro symbol outside the European Central Bank in Frankfurt, Germany

Summary

Germany and France have worked out a proposal for an EU Treaty revision whereby a permanent stability fund would be established and stricter enforcement mechanisms would be created. The proposed changes would give Germany considerable influence over the financial future of its fellow EU member states.

Analysis

German Chancellor Angela Merkel said Nov. 1 that bondholders and investors would be expected to shoulder the costs of bailing out EU member states in the future. The statement sparked a near panic among investors, widening the gulf between yields of Irish and Portuguese government bonds against those of German government bonds. The significance of the statement, however, goes far beyond the short-term effects on investors.

In the context of the planned changes to the eurozone fiscal rules agreed upon at the EU leaders’ summit in Brussels at the end of October, the comment indicates that Germany is designing a post-crisis economic structure in Europe under which Berlin will decide the fates of its fellow eurozone neighbors. This mechanism will function like the International Monetary Fund (IMF) for Europe, and with it, Berlin, like Washington for the IMF, would be planted firmly in the driver’s seat.

**The Proposed Changes**

Merkel and French President Nicolas Sarkozy came to a [compromise on reforms to European fiscal rules](http://www.stratfor.com/analysis/20101019_remaking_eurozone_german_image) Oct. 19 at the French seaside resort of Deauville. Germany accepted the French demand that a permanent stability fund be set up to prevent future existential crises in the eurozone, while France accepted German demands for stricter enforcement mechanisms to make the bloc’s fiscal rules stick and for the reforms to be written into the EU Constitution via a Treaty adjustment. Perhaps most critical from Berlin’s perspective, the new crisis mechanism would presumably also pave the way for an orderly default of a eurozone member state if it is in as dire of a situation as Greece was in early 2010.

Although different EU member states initially opposed the reforms for various reasons, Berlin and Paris managed to cajole them into agreement at the EU leaders’ summit. EU President Herman Van Rompuy will now be tasked with phrasing the proposal — to be submitted at another leaders’ summit in December — so that the new rules at least have the veneer of a unified proposal.

Despite appearances, however, the proposal at its core is a German-designed solution. First, by calling for Treaty ratification, Berlin is forcing all EU member states to fully commit to the new changes. Second, Germany has given in to the French demand that a permanent stability fund — akin to the [European Monetary Fund (EMF) idea](http://www.stratfor.com/sitrep/20100309_brief_german_bank_chief_decries_european_monetary_fund_idea) that was floated earlier in 2010 at the height of the crisis — be set up to replace the current 440 billion euro ($616 billion) European Financial Stability Fund (EFSF) set to expire in 2013. At first glance, it appears that Berlin caved to Paris on the EMF idea in order to push through its enforcement mechanisms on eurozone spending rules. However, the reality is that the EMF only advances Berlin’s goals that were already institutionalized in the EFSF.

**The EFSF**

Near the end of the Greek sovereign debt crisis, Germany realized that it needed to develop a mechanism to enforce its will without acquiring the approval of other EU states if further eurozone countries were to be bailed out. Its solution was the EFSF.



[(click here to enlarge image)](http://web.stratfor.com/images/europe/art/Eurozone-rescue_800.jpg)

The EFSF is not an EU institution like the European Commission or any other bureau. Rather, it is a [limited liability corporation](http://www.stratfor.com/weekly/20100503_global_crisis_legitimacy) registered in Luxembourg; specifically, it is a Luxembourger bank. This peculiar arrangement is by design — it allows the Germans to evade pre-existing EU Treaty law.

While EU law forbids direct bailouts of member states, the EFSF, as a private bank, can engage in any sort of activity that any other private bank can, including granting loans (for example, to European states facing financial distress) or issuing bonds to raise money. The EFSF can therefore bail out member states, indirectly regulate the banking sector, set up a “bad bank” to rehabilitate European financial institutions, or favor one member or penalize another without a unanimous vote — all actions explicitly or implicitly barred by EU Treaty law.

Though eurozone states do not actually provide cash, they guarantee a prearranged amount of assets that the EFSF holds. This raises the question: Where does the EFSF get its funding?

The European Central Bank (ECB) has always provided loans to eurozone banks as part of conducting monetary policy, but only in finite amounts and against a very narrow set of high-quality collateral. In response to the financial crisis, the ECB adapted this pre-existing capacity to begin providing unlimited loans against a broader set of collateral — such as Greek government bonds — and for longer periods of time (up to about a year). This improved capacity to lend to eurozone banks was part of what the ECB has called “enhanced credit support.” Banks put up eligible collateral in exchange for loans, allowing them to have sufficient cash even if other banks refused to lend to them. This is relatively simple, but as the 2008 recession dragged on, the enhanced credit support soon not only [*became* the interbank market](http://www.stratfor.com/analysis/20100630_europe_state_banking_system), but it also became a leading means of supporting heavily indebted governments in the eurozone. After all, banks could pledge unlimited amounts of eligible collateral in return for ECB funds. So banks purchased government bonds, put them up with the ECB, took out another loan and then used that loan to purchase, for example, more government bonds.

This means the EFSF should have two easy methods of raising money if the need arises. First, eurozone banks should have no concerns buying EFSF bonds as they can simply put them up at the ECB to qualify for liquidity loans, assuming correctly that the bonds are still eligible as collateral. Second, because the EFSF is a bank, the ECB could not only allow its bonds to be eligible, but could allow the EFSF to participate in the ECB lending itself. So it can purchase a eurozone government bond (remember the EFSF exists to support the budgets of European governments, so it will be purchasing a lot of bonds), get a loan from the ECB, and use the proceeds to buy more government bonds. In essence, the EFSF could, in theory, leverage itself up just like any other bank.

Furthermore, the EFSF requires no act by the Commission, no additional approval from 27 different parliaments and no unanimous vote among the various EU heads of government to forward its loans. It simply will need “approval of the Eurogroup” — the finance ministers of the eurozone — as its website claims, which at this point is about as authoritative an insight into its potential operations as one can get. The Eurogroup, as the Greek crisis has shown, has been dominated by Germany because Berlin has not hesitated to threaten not to fund bailouts if its terms are not met. Furthermore, the EFSF does not even officially report to the EU leadership, instead taking its cues from its own board of directors — a board led by Klaus Regling, a German.

**The Future: An EMF?**

If we use the EFSF as a template for what Berlin is designing in the future, then we are beginning to discern a picture of a German-designed crisis mechanism. On one hand there is the financial support mechanism, the details of which are largely already in place in the EFSF. On the other hand, as Merkel’s comments indicated, there is a default mechanism that will end the implicit Berlin guarantee that provided fellow eurozone member states with essentially a blank check, in other words an expectation that Germany will bail them out in times of crisis.

Germany wants to establish clear rules for how countries can be allowed to have an orderly default so that both eurozone governments and investors understand that Berlin will not always pick up the pieces. The investors would conceivably then price eurozone governments’ debt appropriately — since German support would now also come with a credible threat of allowing a eurozone country to fail — increasing borrowing costs for fiscally irresponsible states and forcing them to adhere to EU fiscal rules against budget deficits exceeding 3 percent of gross domestic product (GDP) and government debt exceeding 60 percent of GDP.

The combination of a support fund and a mechanism for orderly default will therefore afford Berlin considerable power over the financial future of its fellow eurozone member states. Germany would have control over both the financial life and death in the eurozone. There are few arrestors to Berlin’s plans in the short term, as no country dares to cross Germany at a time when the economic stability of the eurozone is still very much in doubt and still very much reliant on German participation. The only real challenge to Germany would emerge if one of the core eurozone countries, such as France, develops an economy strong enough to challenge Germany’s and offers an alternative to the [Berlin-imposed consensus](http://www.stratfor.com/weekly/20100517_germany_greece_and_exiting_eurozone).