Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

EUROPEAN REFORMS: MERKEL'S DOWN-TO-EARTH RESPONSE TO MACRON

Berenberg Macro Flash

Italy may be heading for a confrontation with bond markets later this year or, more likely, after a potential 2021 recession as its new government intends to reverse reforms and abandon prudence. Spain looks safe as its new Socialist minority government is staunchly pro-European and, lacking a reliable majority in parliament, would not be able to do much economic policy nonsense anyway. Against the backdrop of some political upheaval at the Eurozone periphery and ahead of the EU's 28-29 June summit, German Chancellor Angela Merkel has now spelled out her ideas for European reforms in more detail. In her low-key way, she did so in a lengthy interview with German FAS newspaper. While Paris praised her comments as a significant step closer to the positions that French President Emmanuel Macron laid out 250 days ago, Merkel did not break much new ground. In line with our long-held view of what Berlin could offer, she refined the mostly well-known German ideas and added a few details. That she chose to do so now, and that Paris has responded positively, shows that Berlin and Paris are both eager to make progress on those matters where a consensus seems possible.

Before examining what Merkel said, consider what she did not endorse: Merkel's proposals do not include a Eurozone finance minister worth the name, a big "Eurozone" budget or an elevated role for the EU Commission. While she is ready to offer more money to strengthen growth and cohesion within the EU and the Eurozone, such new funds must come with strings attached. More support for weaker members would be conditional. That is, of course, the opposite of what the new radical government in Rome is aiming for, namely more money while breaching the rules of the Eurozone at the same time.

MERKEL'S DOWN-TO-EARTH IDEAS

In her FAS interview, Merkel proposes to:

- focus on completing a **banking and capital market union,**
- turn the European Stability Mechanism into a **European Monetary Fund,**
- give the EMF a new instrument beyond its current long-term facility so that the EMF can extend conditional credits with 5-year maturity to countries hit by an **external shock** (this is clearer and more detailed than before),
- let the EMF judge the **debt sustainability** of Eurozone members and equip it with a tool to restore debt sustainability if required,
- keep the EMF outside the control of EU Commission so that it remains - like the current ESM - under the **control of member states** and their national parliaments (this de facto veto for the Bundestag is a key German point),
- create an **investment budget** for the Eurozone in "lower double digit billions" to be phased in gradually (for reference, €25bn would be 0.2% of annual Eurozone GDP).

The latter proposal is more precise than before. Merkel says it needs to be decided whether such a fund is to be part of the EU budget or not. The fund should also have the purpose to promote/reward pro-growth pro-growth structural reforms in member countries.

As laid out already in Germany's CDU/CSU-SPD coalition agreement, Merkel repeats that Germany is ready to raise its **contribution to the EU budget** if the extra money is spent for the right purposes. In line with the schedule proposed by Macron and the EU Commission, Merkel would like to resolve the tricky issue of the

EU long-term budget for the post-Brexit 2021-2027 period ahead of the elections to the European parliament in May 2019.

Beyond economic/Eurozone issues, Merkel wants significantly more **EU cooperation on defence and migration**, including more resources for joint border controls. She explicitly endorses Macron's idea of a joint "intervention army". However, she adds that Germany, with a military that is under parliamentary control, may not always take part in joint missions.

Merkel's proposal that the fund should have "adequate instruments" to "restore the debt sustainability of member states if required" sounds like a – potentially quite contentious – procedure for orderly debt restructuring.

Separately, Merkel responds calmly to the radical government in Rome and the recent anti-German rhetoric of 5Star and Lega leaders. She emphasises the need for mutual respect and her willingness to talk to the Italian government, for instance about ways to reduce youth unemployment in Italy. In the same context, she notes that the earlier conflict with Greece about necessary reforms has been resolved in a sustainable way. Reading between the lines, that may well mean that she is bracing herself for the risk of a conflict with Italy.

WHAT TO EXPECT AT THE JUNE SUMMIT?

Italy's new government will not make it easier to achieve a lot at the EU summit on 28-29 June. It may take a while for the Italian radicals to find their place in the European reform discussions and for other EU leaders to find out how fast and far the radicals in Rome may back away from their fiery campaign rhetoric. In her interview, Merkel did not go into any details of banking union discussions such as a roadmap for a joint deposit insurance for Eurozone banks. For the June summit, we continue to expect a general agreement that the ESM (and future EMF) could be turned into the backstop for national bank resolution regimes if required and a bit more clarity (among most participants at least) how much reduction of risk on bank balance sheets will be required before Germany and other countries - mostly from the North-East of the EU - will be ready to take a step on the long road towards a joint deposit insurance. In addition, we should get pledges to discuss key issues within a specified time frame.

Ultimately, the future of the EU and the Eurozone will not depend very much on such reforms at the EU/Eurozone level and on new funds for a few purposes. Instead, the key is whether France continues on its path of domestic reforms that could turn France into an economy that is even more dynamic than Germany. In our view, France remains on track. A French renaissance will bolster the image and cohesion of the EU and the Eurozone. Separately, Italy's radicals will eventually have to choose between a U-turn back towards pro-growth reforms and fiscal prudence or a course that could weaken Italy's half-reformed economy further. As the contrast between fast-growing Spain and Italy shows, the divergence between Eurozone/EU members reflect national policy choices rather than supposed institutional deficiencies at the EU or Eurozone level.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com