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EUROPEAN REFORMS: MACRON AND MERKEL STRIKE THEIR MODEST DEAL

Berenberg Macro Flash

Amid all the noise about Trump's trade war threats and a political crisis in Berlin, the slow process to reform the Eurozone remains on track. On schedule, French President Emmanuel Macron and German Chancellor Angela Merkel yesterday agreed a common list of not overly ambitious ideas to be discussed at the EU summit on 28-29 June. While Merkel/Macron focus on reforming the European Stability Mechanism (ESM), in line with German preferences, they also propose baby steps towards common fiscal facilities, in line with French preferences. Unsurprisingly, the joint proposals fall short of the lofty but mostly unspecific ideas Macron had presented last autumn. They confirm our expectations and conform to standard EU practice: unless a massive crisis forces abrupt change, progress is gradual. It comes in many small steps to be discussed at length among many countries before final decisions are taken. Still, even such a slow process yields results.

Key Merkel-Macron proposals:

- A modest **Eurozone budget** as of 2021 to strengthen convergence, competitiveness and investment in the Eurozone;
- A **new facility for the ESM** to deal with temporary crises or liquidity problems in individual member states;
- ESM to become the **backstop** for the common bank resolution fund by 2024 or earlier;
- further changes at the ESM to turn it into a genuine **European Monetary Fund** (EMF) with a stronger role in the fiscal surveillance of member states.

While the proposals focus on the ESM, in line with german preferences, the Eurozone budget is
ESM/EMF support for struggling member countries will remain conditional, a key German request. On the highly contentious issue of a **European deposit insurance**, Merkel and Macron merely propose to start work on a "roadmap for beginning political negotiations" after the 28-29 EU summit. Beyond the initiatives to enhance the economic coherence of the Eurozone, France and Germany also want the EU to strengthen the **common foreign, security and defence policy**, to establish a joint **border police** and – eventually – a **common asylum office**.

Macron and Merkel have not specified a size for the common Eurozone budget. This budget – one of Macron's key proposals - could be one of the more contentious items at the 28-29 EU summit. A number of mainly Northern Eurozone member countries led by the Netherlands have strong reservations against such a budget. Germany's CSU – the Bavarian Conservatives threatening to walk out of their alliance with Merkel if she does not harden German asylum policy significantly – have reportedly asked for an urgent discussion about it among leaders of Germany's CDU/CSU-SPD coalition. Still, compromises on this issue should be possible in the end, probably with new facilities for strengthening Eurozone investment and convergence within the framework of the EU's long-term 2021-2027 budget. Merkel and Macron also pledge to "examine the issue of a **European Unemployment Stabilization Fund**", a conditional credit-based backstop for the unemployment insurance system of member countries hit by major asymmetric shocks. German finance minister Olaf Scholz has recently promoted this idea as – so far – his only major step beyond the direction set by his predecessor Wolfgang Schäuble.

Does the French-German proposal matter? In a way, it does. It shows that, the Eurozone continues to move ahead slowly. It will be difficult to take many decisions at the 28-29 EU summit already. The not-yet clear views of the new Italian government and the renewed focus on contentious issues of asylum policies are adding to the complexities. However, the outlines of some modest Eurozone reforms (more money for specific purposes, slow steps towards banking union, stronger ESM) are becoming clearer.

Of course, whether the Eurozone will get stronger and more resilient to future shocks will depend mostly on decisions taken at the national level, not on tinkering with its governance structure. If Italy reverses pro-growth reforms and abandons fiscal discipline, it will be more vulnerable to future bouts of crisis regardless of the precise shape of a future European Monetary Fund and the size of any Eurozone budget. If Italy flouts the rules badly, it would not be eligible for such additional funds anyway. Conversely, the ongoing reform process in France (reform of SNCF railways passed with sizeable majority in the French parliament last week) will do more to strengthen France than any Eurozone budget ever could. If a stronger France joins a still-strong Germany while Spain remains on track, other members of the Eurozone and the EU would benefit significantly from having dynamic neighbours and trading partners. Progress on the EU/Eurozone level helps. But the real issues are to be tackled at home.

Macron and Merkel's "Meseberg declaration" also contains a vague reference that, in the context of the ESM's debt sustainability analysis, the Eurozone should "start working on the possible introduction of Euro CaCs" (collective action clauses) and potentially let the ESM "facilitate the dialogue between its Members and private investors, following IMF practice". In line with a long-standing German demand, this would leave a hypothetical option of orderly debt restructuring in future ESM/EMF programmes on the table. It remains unlikely that it would be activated in the foreseeable future.

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