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Is the Grand Coalition Leading Germany towards a Transfer Union? The Euro Junktim*

The CSU/CDU and the SPD are currently coming under fire for seeking to turn the Eurozone into a transfer union. Firstly, criticism is directed at their plan to enshrine the ESM euro bail out mechanism in EU law. This raises the question of whether the German veto on bail-out credit for countries with financial difficulties will be weakened. Secondly, the coalition wants to create a new fund conceived as the starting point for a future investment budget in the Eurozone. Although the coalition partners also say that the principle of linking control to liability in the Eurozone will continue to apply in the future, this is cold comfort. This principle has already been greatly weakened: not only through the bail-out credits granted to Greece that probably will never be repaid, but primarily through the TARGET balances in the ECB System. Via TARGET, Germany has granted other Eurozone countries interest-free credit worth over 900 billion euros for an undefined period of time. And this figure is rising. Germany urgently needs to scrutinise any uncontrolled increase in liability for other states. The grand coalition is doing just the opposite. It is moving in the direction of greater redistribution and joint liability. In line with these developments, Germany's acting Finance Minister Peter Altmaier has signalled in Brussels that Germany would agree to a Eurozone deposit insurance scheme. He has warned that the volume of bad loans in the banking system needs to be reduced but this is not enough.

The dangerous signal being sent here is that Germany is prepared to negotiate over greater risk-sharing in the euro area with nothing demanded in return. Nothing is being done to protect Europe's taxpayers from being held liable for the liabilities of other countries and their banks. Nothing is being done to maintain the indispensable balance between solidarity and responsibility.

Any form of insurance reduces incentives to avoid accidents. Insurance schemes are nevertheless useful, but must be combined with measures that hold disincentives in check. That is why steps towards greater solidarity must be linked with better precautionary measures to ensure sound economic and fiscal policy.

What is to be done? Many critics of more joint liability in the euro area think that Germany should simply say no and reject greater risk sharing out of hand. This strategy is not very promising for two reasons. Firstly, it may slow down the drift towards a transfer union, but it will not prevent it. Secondly, such a refusal would not change the fact that in the next crisis Germany will be trapped in a situation where accepting liability for afflicted states is without feasible alternative.

The aim of Eurozone reform must be to avoid this trap, or that is to eliminate the basic preconditions for this predicament. The main reason why Germany had to accept bailing out other countries in the last crisis lay in the financial ties between banks and states in the Eurozone. Back when Greece was on the verge of bankruptcy, applying the no-bail out clause would have triggered a banking crisis, because European banks had massive volumes of Greek sovereign bonds on their books, but hardly any equity to absorb their potential losses. This problem has grown worse in recent years. Italian banks now hold more Italian government bonds than at the outbreak of the euro crisis. If the capital markets were to lose confidence in the Italian government, the other states in the Eurozone would be forced to help Italy. The alternative, namely the risk of an unpredictable banking crisis, would be too daunting to contemplate, even for a German federal government that did not really want to intervene.

The banks' financial involvement in domestic government bonds is even more dangerous if it is coupled with joint deposit insurance. In this case individual member states could restructure their public debt at the expense of the deposit insurance scheme. Banks could use their customers' deposits to buy government bonds, and when the bonds are written off demand this money back from the European deposit insurance fund. In a currency union with joint deposit insurance, banks that can buy unlimited volumes of government bonds are like a powder keg waiting to explode.

Germany should opt for a Eurozone reform concept that I refer to as the Euro Junktim, a package deal where greater solidarity must be accompanied by a strengthening of the ties between control and liability in economic and fiscal policy. Germany should make four demands: firstly, bank investments in government bonds should be limited to the extent that defaults on these bonds can no longer trigger banking crises. Secondly, bad loans in the banking system need to be reduced faster than they have been to date. Thirdly, fiscal discipline should be strengthened by obliging countries that exceed budget deficit thresholds to finance their excess debt with subordinated bonds (accountability bonds). Fourthly, better precautionary measures should be taken with regard to the ESM, so that no bail-out funds are granted to over-indebted states. Germany should only agree to greater risk-sharing through a Eurozone budget if these conditions are met. If not, it should stand its ground.

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