OSW COMMENTARY
ISSUE 71 | 07.03.2012 | CENTRE FOR EASTERN STUDIES

The fiscal compact – Europe's 'hard core' based on German economic conditions

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On 2 March, the leaders of 25 EU member states signed the *Treaty on stability, coordination and governance in the economic and monetary union*. It will introduce new fiscal constraints and officially vest new competences in the eurozone countries. Thus, their right to coordinate economic policy among them will be sanctioned. So far, the Lisbon Treaty has only provided for organisation of informal Eurogroup meetings, to be attended by representatives of the European Commission. The principles introduced by the compact, if the eurozone countries are really determined to observe its provisions, will create a new way of managing the single currency. Within the next few years, the most indebted countries will have to carry out radical reforms to boost their competitiveness and adjust it to German standards. During this period the Federal Republic of Germany will most probably decide to offer higher loan guarantees to relieve these countries' budgets. The compact's political consequences are also of great significance, especially considering how the treaty was finalised. The eurozone states have in fact accepted that the direction for changes will be devised by France and Germany, and the role of European institutions such as the Commission or the Parliament may weaken. From the perspective of eurozone candidate countries, the introduction of the fiscal compact means expanding the scope of conditions they must meet to become members of the single currency area. In the future, a country, in order to adopt the single currency, will have to meet the structural deficit criterion, and also most probably carry out economic reforms such as unifying its fiscal system. These goals will be achieved across the eurozone gradually, in the subsequent stages of the economic governance reform.

The compact's final version and the context of its introduction

The leaders of 25 European Union member states, the United Kingdom and the Czech Republic excluded, have agreed to sign the fiscal compact pushed through by Germany. Under this compact, the eurozone states will be obliged to keep their structural deficit (which does not include one-time expenses and expenses related to excess unemployment figures) at a level not exceeding 0.5% of GDP. Only in the case of a serious economic slump caused by external factors can this obligation be bypassed. The new balanced budget rule is to be incorporated into the legal system of each of these countries. If any of the states fails to introduce this clause, any other state can bring a case to the European Court of Justice, which will be entitled to impose a penalty on such a state amounting to 0.1% of GDP. Furthermore, the agreement incorporates into the legal system an obligation upon eurozone states to meet at least twice a year (so far the summits where important decisions relating to the whole EU were made have been informal). If at least 12 states ratify the compact, it will come into force on 1 January 2013.

The non-eurozone countries were also allowed to join the fiscal compact. If they do so, they will be able to attend some of the eurozone meetings devoted to "the euro area's competitiveness, and modifying its general architecture & the fundamental rules that will apply to it in the future". This, however, is more of a political declaration of support for the eurozone, as it will not be necessary for the non-single currency countries to meet the structural deficit requirement. The rather unclear wording of the clause relating to the subject matter of the summits to be attended by non-eurozone countries may turn the matter of inviting them to key meetings into one element of a political game. For example, France's President Nicolas Sarkozy has claimed that the non-eurozone states will be invited only to the Euro Plus group meetings, which are debates devoted to boosting the eurozone's competitiveness.

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Unlike in the draft adopted in December 2011, in the fiscal compact's final version the clauses concerning fiscal obligations were moderated, and the possibility of bypassing them in extraordinary economic circumstances was introduced. Furthermore, Germany has dropped its proposal to incorporate the compact's provisions into the constitution, as this could disable the ratification process in some states, for example in Ireland, where a referendum would be necessary. Despite these adjustments, Ireland has already announced that a ballot is unavoidable. In the final version, the title of the document was also changed from the original 'International agreement on a reinforced economic union' to the 'Treaty on stability, coordination and governance in the economic and monetary union', probably to highlight the agreement's importance, especially in relation to EU treaties. A provision was added to the final version of the compact stating that within five years of the date of its coming into force, the necessary steps shall be taken to incorporate its substance into the legal framework of the European Union.

The fiscal compact's political significance

The fiscal compact is an important document which will initiate the process of building the monetary union's political dimension. The French concept, on the basis of which it was assumed in the early 1990s that the introduction of the single currency would give an impetus for the automatic creation of a political union, has proved wrong[1]. Over the last decade the single currency states have made little progress in this area, and it was only the scale of the eurozone debt crisis that forced them to deepen their cooperation.

The way in which the fiscal compact was adopted demonstrated **the growing position of Germany in Europe**, as most of the proposals included in it were submitted by Germany. From the French perspective, the goal of **limiting the debate on the eurozone to the group of countries which use the single currency** was attained, as according to the country's elites the exclusion of Central Europe and the United Kingdom increases the political chances of pushing through the solutions proposed by France, mainly by way of negotiations with

[1] In the 1990s, the dispute over the creation of political institutions to facilitate the governance of the monetary union was a major bone of contention between Germany and France. At that time, the Germans believed that one of the main weaknesses of the Treaties of Maastricht and Amsterdam was that they failed to establish foundations for a political union to guarantee joint coordination of the eurozone's governance.

Germany. France considers it a success that Germany was persuaded of the need for deeper integration in the eurozone. So far Germany has avoided any debates on this, fearing that the European Union might split, but most importantly that the German social market economy model – which it considers exemplary – might be reviewed. From the perspective of these two states, it seems favourable to **isolate the institutional reform of the eurozone from the institutional agenda of EU treaties**, as this would accelerate and simplify the decision-making process and limit the role of EU institutions.

It seems that it was not exclusively the persuasive strategy of France that induced Germany to change the integration concept in the immediate future. Apparently the German elites have come to approve of integration within the 'hard core'. The first sign of such a change in the German thinking was the introduction in 2007 of a provision to the Lisbon Treaty concerning enhanced cooperation in selected areas among the interested states. The United Kingdom's veto on the incorporation of the compact into European treaties proved a favourable pretext for Germany to abandon the concept of European integration across the whole EU, which had hitherto been officially promoted, in favour of deepening cooperation within the 'hard core'[2].

Equally significant was the fact that consent to limit integration to the group of eurozone states might facilitate the re-election of Nicolas Sarkozy as President of France, as Germany fears that victory for a socialist candidate in the French presidential elections could lead to tension in relations between Paris and Berlin and disable the eurozone reforms. Germany's ruling coalition politicians would also welcome a victory for Sarkozy because he would accept Germany's dominant position in the eurozone, and would be ready to carry out reforms in France based on the German model, aware of a growing economic disparity which is shifting in Germany's favour.

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Another argument in favour of the return to the concept of the 'hard core' was that Germany was persuaded that the Lisbon Treaty was ineffective and inappropriate for the problems faced by the eurozone. From the perspective of the current crisis, it is evident that the Treaty has failed to introduce sufficient powers to enable more efficient governance of the single currency. Furthermore, the voice of the Federal Republic of Germany on the EU agenda is still too weak to push through the country's major proposals, as evidenced by the fact that even the so-called 'Six-pack' (a package of six reforms to economic governance in the EU) has failed to introduce a fully automatic method of imposing sanctions for excess budget deficit. Furthermore, the law-making procedures based on the rules provided for in the Lisbon Treaty are too lengthy, and have not kept pace with developments resulting from the eurozone crisis and the corresponding reactions on the financial markets.

Marginalising EU institutions – a stop-gap measure or a long-term strategy?

The way in which the fiscal compact was adopted has demonstrated a certain marginalisation of the European institutions, whose role – according to the Lisbon Treaty – was supposed to be significant. Neither the European Parliament nor the European Commission has had a major impact on the draft, and their role as specified in the compact's provisions is merely symbolic. The process of drafting the document was no different from the decision-making process during the eurozone crisis, which has now been going on for two years. Therefore, had the United Kingdom not vetoed the incorporation of the treaty into the EU's

[2] Germany has returned to the concepts it had been considering in the mid-1990s, when various strategies for deepening integration within Europe's 'hard core' were being analysed. It was only the German priority of enlarging the EU eastward that set those ambitions aside at that time. As early as then, Europe's 'hard core' was to be based on those states which had the strongest connections with Germany, mainly the Benelux countries and France.

legal framework in December 2011, the EU bodies would not have played any major role in negotiating its content anyway. Public opinion in numerous European countries is getting used to the **new way in which the European Community functions**, and so there were no protests even last December, when France and Germany announced the compact's main framework at the summit. This was considerably different from the situation in March 2011, when France and Germany were heavily criticised by most European countries for creating the basis for the Euro-Plus Pact, and originally the competitiveness pact, without consulting with their other partners.

In Germany, the **European Commission** is generally perceived as **a body which is interfering with the process of healing the eurozone,** and has no legitimacy to impose any solutions relating to the eurozone on the national governments. A relevant example here is the strong opposition towards most of the proposals submitted by the European Commission, including the one concerning Eurobonds. The attitude of the European Commission's President was also repeatedly criticised, and his proposals were rejected as attempts to defend the Commission's position in the EU. However, it is worth noting that the EU institutions' competences have been expanded in certain areas. The compact has confirmed **the European Commission's role in imposing EU sanctions** for breaching the 3% budget deficit limit. Its decision to penalise a country can only be vetoed by qualified majority voting. This shows that despite its scepticism towards the European Commission's political importance, Germany sees it as a guardian of EU law and does not intend to weaken this role. This is why Germany will strongly support the European Commission in enforcing the macroeconomic and fiscal balance provisions, as it wants to avoid repeating the current economic problems. The so-called 'budget brake'[3] will be a strong motivation even for federal governments headed by future ruling coalitions. The consent of German public opinion to the need to implement this objective will induce the federal government to push through the obligation to observe the budget rules across the eurozone.

There is a risk that the fiscal compact might be used as an instrument to establish law for the whole community.

Initiatives to be undertaken in the eurozone in the near future will show the relation between the eurozone and the remaining EU member states. There is a risk that the fiscal compact might be used as an instrument to establish law for the whole community. An example of such an action could be the announced proposal to introduce a tax on financial transactions. It will also be binding on financial institutions based in the non-eurozone EU states which carry out most of their transactions in cooperation with entities based in the single currency area. So, if the decision on this matter is taken unilaterally by the eurozone states without appropriate consultations with the remaining partners, it could be considered **an attempt to push through projects of considerable importance for the whole European Union in the eurozone first,** and to force the other EU member states to implement relevant adjustments. In the long term, this situation could accelerate the marginalisation of the European institutions, or cause a partial delegation of their administrative competences to the individual eurozone countries.

Still, it is possible that German support for non-treaty based reforms of the eurozone is the right solution for this time of crisis. In the longer term, the EU's institutions can be useful in implementing Berlin's most important goals in such areas as energy and climate policy, and in deepening economic integration and commercial relations. This is why in the next few years Germany can concentrate on the eurozone reforms, and try to highlight the importance of the whole EU by drawing attention to the great importance of the European institutions, keeping the EU budget relatively high, and emphasising a policy of cohesion. Germany might fear that excessive emancipation of the eurozone from the EU institutions

[3] Incorporated into the German constitution as of 2009, this constitutes an obligation to keep the structural deficit in Germany at a level not exceeding 0.35% of GDP as of 2016.

might discourage the Central European countries from developing their integration with the eurozone and encourage to adopt a more assertive policy, and block important projects proposed by Germany within the EU, such as the common climate and energy policy. This could also limit the benefits Germany has derived from the EU's enlargement[4].

The fiscal compact's economic importance

The new compact is intended to restore fiscal discipline. In practice, its introduction means that those national governments which are in breach of the new discipline rules will be held accountable before national bodies. It is difficult as yet to assess how effective this solution will be. If the principle proposed by Germany proves enforceable, the single-currency states, in particular the less competitive ones, will have to carry out deep structural reforms – not only to curb their expenses, but also to change the functioning of their social systems and labour markets. Signing the compact will mean a *de* facto agreement that most countries – such as Spain, Portugal, Italy or even France – would have to **adjust their systems to the German economic model**; that would mean these states would incur most of the costs of such a transformation. In practice, this would mean the necessity to control expenses even in good economic conditions, when the debt financing costs are usually much lower. The structural deficit limit is defined so as to allow for slightly higher deficits in less favourable economic circumstances, and to keep the deficit low in good economic conditions.

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It is uncertain whether the reforms proposed by Germany and France would enable the southern eurozone countries to regain their competitiveness. So far, **their participation in the single currency project has led to a growing disparity in their balance of payments.** In these states, which are deprived of the ability to weaken their respective currencies, imports have risen much faster than exports, which during the crisis period has led to a rapid and significant increase in their foreign debt[5].

In the foreseeable future, both Germany and France will most probably call not only for spending cuts, but also for **income reforms**, possibly by formulating proposals for the unifying the method of calculating the tax to be collected from businesses. Both countries believe that so far, due to the CIT rate being too low, some states (Ireland in particular) have been competing unfairly with others. In February 2012 Berlin and Paris announced a plan to harmonise tax systems in their countries, so a proposal calling for a similar reform in the eurozone is very likely. Furthermore, incentives to **reform the labour markets according to the German model** are to be expected. In 2004–2005 Germany introduced the following modifications: temporary forms of employment have been made more flexible, unemployment benefits have been reduced and the retirement age lifted. However, it is hard to assess whether any of these solutions could be successfully applied in other eurozone countries.

The example of Greece has shown German politicians that savings alone can magnify the scale of a country's economic problems. This is why Germany has suggested transferring some of the money from structural funds to support programmes aimed at reducing unemployment among youth and young adults, with the intention of showing their readiness to offer investment aid to those southern countries which are striving to modernise their economies. Considering that Germany will not be willing to offer more funds to support investments in the eurozone's weakest countries, it may **want to increase payouts from the structural funds for those countries, at the expense of funds contracted for Central Europe.**

[4] In 2010, the Vysegrad Group states alone purchased German goods worth of €87.2 billion, comparable with the value of the German export to France (€89.5 billion), Germany's largest trade partner. The total value of import from those countries (€81.9 billion) was higher than the respective figures for imports from China (€77.3 billion), the German market's largest supplier.

[5] This has also contributed to a rise in the unemployment rate, as the goods consumed in these countries had been manufactured abroad. This is one reason why German unemployment figures are at a 30-year low. In the 1990s, before monetary union was established, the opposite situation prevailed, due to the foreign exchange policy adopted by Germany's trade partners among other reasons. Germany's current account was much lower, and consequently, its unemployment rate was convergent with the EU average.

Germany's rhetoric towards Greece[6], as well as the compact's provisions guaranteeing its coming into force after just 12 out of the 17 eurozone states sign it, may mean that Berlin has growing doubts as to whether the fiscal situation in Greece can be remedied, and **is ever more seriously considering the option of its controlled default**. In January 2012, the Bundestag agreed to revive the bank aid fund which had existed in 2007–2010, and currently has €400 billion of financial guarantees at its disposal. According to press reports, a few weeks earlier Chancellor Angela Merkel met with the heads of Germany's largest financial institutions to announce that they should start preparations for the possible insolvency of Greece. To secure the system against the consequences of Greece's default, it would probably be necessary to increase the volume of the loans offered to the remaining eurozone states. An improvement in the economic situation in Spain or Italy could convince the financial markets that there is no threat of default in any of the big eurozone states. However, it cannot be ruled out that Greece remaining in the eurozone would be conditional on its accepting some form of supervision by EU institutions over its budget.

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The savings in the eurozone could also exert pressure on the German economy, which depends on exports to a large extent. In the context of the necessity to make savings imposed by the compact, which will additionally lead to public spending cuts and labour cost reduction in a number of the eurozone countries, this may cause a decline in the volume of German exports to the eurozone (which account for around 40% of the country's total export). Therefore, from the point of view of German business, the importance of other markets (including Central Europe and the emerging economies) will grow. From the German perspective, the political significance of China, India and Brazil, whose rapid development might balance the expected decline in German trade within the eurozone, is likely to grow as well.

Opportunities and risks of implementing the fiscal compact

One certain consequence of the pact's signing is the launch of the process of creating a political union within the eurozone step by step. The eurozone has organised meetings devoted to coordinating economic policy within the monetary union since 2009, which was when the eurozone crisis worsened. However, the fiscal compact has expanded the competences of these summits and increased their political importance. The increased political pressure on the compact's eurozone signatories will also result from public interest in the fiscal situation in these countries. So far, the lack of an institutional framework for these summits has been a problem for the eurozone. The states will remedy this by charging their national ministries with the task of drafting subsequent reforms, as evidenced by the cooperation between the French and German finance ministries in unifying their corporate tax laws. Any support offered by the EU institutions can in fact be blocked by the United Kingdom.
It is still uncertain whether the compact's budgetary constraints will be maintained, and political pressure will continue to be an important condition of whether the eurozone signatories will meet the compact's requirements. Germany's economic position within the eurozone has increased in times of the global crisis and its political power is stronger than a few years back, so pressure from it to stick to the compact's provisions will grow. At the domestic level, Germany has incorporated the budget rule into its constitution and has been consequently carrying out spending reforms, so as to keep its structural deficit

[6] The new tone of the debate, and the radicalisation of the German position towards Greece, are evident in proposals such as creating a post of EU savings commissioner, who could be entitled to supervise the Greek domestic budget for a specific period, and veto any expenses which have not been consulted with international institutions. Germany's proposal has been criticised by most of the other states, and has not become a subject for debate.

no higher than 0.35% of GPD as of 2016; this makes it very unlikely that Germany would ever again break the rules of the compact it has pushed through. If implemented, the fiscal compact's economic principles as pushed through by Germany would mean subjecting the rules of the eurozone functioning to the German economic doctrine of a balanced budget. If the savings turn out to be too radical and the level of investment falls, the economic situation may worsen and the eurozone's economic problems might deepen. In such a case, some of the eurozone members might not be able to keep to the compact's rules, resulting in either their leaving the eurozone or a decline in the compact's credibility.

Another important threat to the fiscal compact is its failure to consider the eurozone's most significant problem, namely the scale of disparities among its members' balances of payments. Due to their limited competitiveness with the northern economies, the monetary union's southern states have had to increase their imports, which led to a sharp rise in their debt. There is a risk that in order to accelerate the reforms of the southern economies, Germany will agree to increase the volume of investments there from the structural funds, possibly at the expense of the Central European countries. On the other hand, Germany should expect a hostile reception in Central Europe to such a solution, so the scale of any such budget shift should be rather limited. Otherwise this could squander the benefits of the EU enlargement of 2004, which so far has been economically very favourable for Germany.

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The fiscal compact does not introduce any significant new instruments, yet it can be considered an important political signal that the eurozone intends to integrate its members. This is evidenced by some states' objections towards any deeper involvement of EU institutions, and to the participation of all EU member states in the eurozone meetings. France strongly supports basing any further integration on the monetary union, which would allow the influence of Central Europe and the United Kingdom on decisions made within the eurozone, and also probably within the whole EU, to be limited. So far, it is difficult to assess whether Germany has been persuaded to adopt this method of political decision-making in the long-term perspective, or whether it intends to cooperate with France temporarily use the fiscal compact, in order to pursue their national political aims alone.

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