Why Merkel had to U-turn on EU ‘recovery fund’

The Franco-German agreement on the EU’s Coronavirus ‘recovery fund’ is already being met with criticism from both sides of the Eurozone divide. This report from Germany explains Chancellor Merkel’s U-turn, and looks at the difficulties that still lie ahead in implementing the agreement.

This is an edited version of a report by the German foreign policy portal ***German-foreign-policy.com****. The original report, including full references, can be viewed here.*

The Franco-German Agreement

Last Monday’s Franco-German agreement on a ‘recovery fund’ has been referred to as Chancellor Merkel’s ‘volte-face’. Merkel has abandoned the previous German position that EU support in the fight against the Corona crisis should only be provided in the form of loans, but under no circumstances as non-refundable grants. Berlin no longer opposes the latter. To finance the fund, the EU should issue bonds for the first time. Their repayment is only planned for the years after 2027 and will be extended over a protracted period – some speak of several decades. Repayments should be made jointly by all EU members and the shares could be calculated according to the ratio that determines the individual members states’ contributions to the EU budget.

Caught in a Dead-End

The reason Germany has finally agreed to provide the resources as grants is because Berlin found itself caught in a dead-end with its previous Corona-crisis policy. Providing financial aid exclusively as loans would be risky. In the fight against the Corona-crisis, all countries concerned have no choice but to shoulder massive debts. The total debts of some countries in the southern eurozone will reach dangerous levels. If additional EU loans were added, the debt burden could easily become unsustainable and require a debt write-off. Needless to say, creditors want to avoid this risk at all costs. Crucially, those creditors include German banks: The Deutsche Bank alone holds €30 billion of Italian government debt.

In addition, the recent ruling of Germany’s Constitutional Court has put the bond-buying by the European Central Bank (ECB) into question, which has limited the options for responding to the Corona-crisis. The ECB is explicitly still refusing to yield to German pressure and restrict its bond-buying, which has become an indispensable means of managing serious structural imbalances within the Eurozone. But the fact remains that following the ruling in Karlsruhe, the sustainability of this instrument has been thrown into doubt.

Political Pressure on Germany

In addition to the growing lack of economic alternatives, political pressure is also escalating. At the beginning of the Corona-crisis the German government had provoked massive resentment in the southern euro countries, with its initial ban on the export of medical protective gear and its adamant refusal to agree to issuing ‘Coronabonds’. This resentment even spread to traditionally EU-loyal sectors of the German political elite.

Then the demand that the Southern European countries most seriously affected by the pandemic accept credit from the European Stability Mechanism (ESM) fund provoked even more hostile reactions. During the euro crisis, these ESM credits were linked to strict austerity obligations, leading to budget cuts in healthcare systems, now having fateful consequences in fighting the Covid-19 pandemic. Most recently, angry protests were provoked by Germany's Constitutional Court's ECB ruling, in which the court in Karlsruhe claims a higher jurisdiction than that of the European Court of Justice (ECJ) – a claim that would have provoked sharp rebuke had courts in other EU member countries, for example in Poland or Hungary, laid claim to the same sovereignty. German concessions to the recovery fund were unavoidable 'if they wished to avoid risking a serious political crisis, to accompany the continent's inevitable economic crisis.' This is now being admitted even by commentators who oppose the Franco-German proposal.

Europe, Europe, Europe

A rampant escalation of political tensions in the EU would, from Berlin's perspective, be even more disastrous than the Corona-crisis, threatening a setback for Germany and the European Union in global power struggles. The CEO of Germany's mighty Siemens Group, Joe Kaeser predicts that, 'the USA and China will probably emerge reinforced' from this crisis. Due to the pandemic, the USA 'will promote digitalization at a much faster pace', to the advantage of the large US internet corporations. China, on the other hand, has been able to gain control of the pandemic much faster than Germany and the EU.

Particularly dangerous for the German economy, says Kaeser, is the fact that the USA is working toward decoupling from China. Siemens generates 20 percent of its sales in the United States, and already 12 percent in China. In this conflict, German industry is in danger of being ground between the millstones of the two world powers. The only way out is a reinforcement of the EU. Kaeser calls for 'Europe, Europe, Europe – governments can choose in which order.'

A small price to pay?

In light of all of thee factors, Merkel has made unavoidable concessions to achieve the recovery fund. Of course, these are minimal concessions. Well-connected observers insist that the measure would be introduced under the EU Treaty’s Article 122 – which explicitly refers to exceptional circumstances. Therefore, these measures must be a one-off. In addition, the Chancellor has brought France’s original demand that the recovery fund must contain if possible €1.5 trillion, but at least €1 trillion, down to €500 billion.

Beginning in 2028 at the earliest and stretched over decades, Germany will have to repay €135 billion. Expensive as that is, it is a small price to pay to preserve the EU’s single market, which, according to a Bertelsmann Foundation analysis, provides Germany with around €88 billion in additional income growth annually. The Franco-German agreement has also helped Germany by removing the issue of Coronabonds from the discussion.

‘Merely a Step’

It is still uncertain whether the Franco-German recovery fund agreement can be implemented in the EU: Austria, the Netherlands, Denmark and Sweden are the main opponents to grants rather than loans. Meanwhile, Italy’s Prime Minister Giuseppe Conte maintains that the proposed recovery fund is insufficient to help his country overcome the Corona-crisis. According to Italian media, Rome can possibly hope for €80 – €100 billion from the fund. For this, it will have to pay €55 billion to the EU calculated in accordance with the usual budgetary ratio. The net grant would therefore be from €25 – €45 billion. The most recent estimates see Italy confronting a more than 10 percent drop in its GDP – more than €180 billion.

The Franco-German proposal for the recovery fund, declared

Conte on Wednesday, is a significant ‘step’ toward a response to the pandemic, but only that: ‘If we are to overcome this crisis together much more needs to be done.’ Otherwise, this crisis ‘will jeopardize the entire European project.’ The EU will ‘suffer a severe blow, marginalising our economic and political position in the world.’