What Lies Ahead of Germany's Leadership Role in Europe

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Abstract

After almost a quarter of a century since the fall of the Berlin wall, Germany has undoubtedly become the uncontested nerve-centre of the European Union (EU) in both economic and political terms, evolving not only as Europe's most important economic power, but also as its de facto leader in terms of economic policy. Considering the negative consequences generated by the severe sovereign debt crisis that hit EU and Eurozone specifically and the further risks that this has provoked, reshaping Europe's architecture became of vital importance for the future of European integration. Under these circumstances, major changes are needed in order to redesign EU's configuration with a view to better withstanding the potential future crisis, to accomplish budget consolidation and to implement structural reforms in support of a deeper integration. The present paper aims to highlight the importance of Germany's pivotal role in such a complex process and the necessity for it to exercise more leadership in order to help Europe to overcome the crisis and conflicts. Furthermore, our analysis emphasizes Germany's current economic strength and its new geopolitical weightiness, factors that endow the biggest European economy to take the lead more decisively in the interest of safeguarding and farther developing the UE.

Keywords: *Economic and political power, Germany, sovereign debt crisis, European integration, leadership.*

JEL Classification: *E, E61, E65, F01, F02, F43.*

1. Introduction

Undoubtedly, Germany has always been an important player in the EU ever since its foundation, in the early 1950s. Still, as it is largely agreed (Dullien, 2013), at the heart of Germany's current pre-eminence in Europe is its recent economic success. Furthermore, when the euro crisis has changed political and economic relationship within the EU – by dividing the club of apparently equal countries into groups of creditors and debtors – owing to its economic strength, Germany became the largest creditor country. Accordingly, it has gained substantial political clout, becoming EU's uncontested leader, at both political and economic level.

The European financial and sovereign debt crises have caused great turbulences in the Economic Monetary Union (EMU), threatening the stability of the entire currency area and starkly revealing the shortcomings in its existing structures. Since 2010, under the menace generated by the tensions in euro area sovereign debt markets, crucial reforms have been set in motion at European level, in order to remove the revealed vulnerabilities in the economic and fiscal governance of the monetary union. Designed to overcome the crisis and return to stability, the policies that have been agreed – along with the introduction of the European Semester, establishment of European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) firewalls, as well as setting up of the single supervision mechanism for banking governance under the European Central Bank (ECB) – have represented at the time the appropriate ways to address the structural deficiencies in the EMU (Becker et al, 2013). Nevertheless, as major challenges still lie ahead, it is necessary to undertake additional actions to ensure that the Eurozone member states conclude binding, enforceable, democratically legitimate, compatible reform agreements EU wide. In this sense, many authors state (Belke, 2010) that a stronger and more effective commitment to crisis avoidance and leading to a deeper integration might be the requisite solution to tackle the remaining problems depressing the euro area. This should enable the achievement of competitiveness goals, sound, sustainable, stable finances – the robustness of the banking sector – as well as growth and employment coupled with solidarity.

At this new juncture, as the largest, most powerful and prosperous economy in Europe, Germany has an imperative interest in deepening European integration, an essential condition in this matter being that EU overcomes the current economic stagnation and severe fiscal constraints. Furthermore, as the long-term prospects of strong growth for Germany are greatly depending on the economic recovery and stabilization of the euro area, it has to assume a more active role and to take the lead in this field more regularly and firmly for a larger achievement of the European objectives and for the common benefit of all the member states, namely of the EU as a whole.

An additional argument for Berlin authorities to assume a higher responsibility and to undertake the role of an “iron fist”, required to sustain the long-term viability of the European integration project is represented by the calls from the European leading politicians, expecting Germany to accept the accountability and liability of political leadership in accordance with its dominant economic position within EU[1]. Consequently, EU’s policymakers expect Germany’s approach to the Eurozone crisis and a coherent project that can serve as a benchmark in the further common actions. As it is stated in the recent economic literature (Guérot, 2013) there is a strong need for Germany’s greater involvement on three specific fronts: building a solid banking union, a growth strategy and a greater commitment to European foreign policy.

2. Why Germany?

Since the very beginning of the crisis, when the fundamentals in the EU have shifted dramatically, the member states have pursued for a joint strategy aiming to achieve the overdue consolidation of public budgets, under the strong pressure of austerity prescription imposed by Angela Merkel, to overcome economic imbalances by improving the economic competitiveness of all Eurozone countries. Germany’s central role in EU’s response to the euro crisis was due to its currently strong economy that put it in a position of control, diminishing the usual power balances in the EU. Moreover, France’s economy has been weakened by sluggish growth rates and a high unemployment while other important players such as UK and Poland were not involved in the decision-making

[1] Many policymakers across EU have urged Germany to take authority over European crisis management. Relevant in this matter is a statement of the Polish foreign minister, Radek Sikorsky, at a conference held in Berlin, at the German Council of Foreign Relation: “I fear German power less than I am beginning to fear German inactivity” (Sikorsky, 2011).

process that was largely limited to Eurozone members. Besides, Germany's pre-eminence was further expanded by the existing segregation inside the EU over how to respond to the euro crisis[2].

Under these circumstances, in a spirit of partnership with other major economies from EU – especially with France, with which acted jointly as a self-appointed centre of the Eurozone crisis management system[3] – Germany felt it was its duty to take on the leadership toward the mutually agreed strategy for solving the crisis in Eurozone (Schäuble, 2013) and ensuring economic security for all its fellow EU member states.

Nevertheless, as it is commonly agreed, the unique political structure that is EU does not lend itself to a leader/follower dynamic and it will never be led by a single country as long as by definition it signifies the equal coexistence of all its member countries. It also should be noted that there was not a German plan or desire to exercise this leadership but this role had rather been thrust on Germany by circumstances. As the biggest and the strongest economy of EU, Germany could not avoid its responsibility during the Eurozone crisis, while other potential leaders among the important economies had either chosen to step aside (UK) or were facing many economic difficulties of their own to be able to take the leading role (France, Italy, Spain). Furthermore, the crisis laid exposed the weaknesses of the EU's institutions and proved that the European Commission was technically and politically unprepared to take the lead and to react rapidly in managing critical situations (Guérot&Klau, 2012). Germany became therefore a reluctant leader, still adapting to its new position and focusing not only on keeping Eurozone and EU intact, but also on increasing the economic competitiveness of other member states and also of Eurozone and EU as a whole.

2.1 German economic miracle – from the "sick man of Europe"[4] toward its economic engine and the anchor of stability

If in the late 1990s and into early 2000s, Germany was often called "the sick man of Europe", after the Great Recession[5], due to its economic impressive economic success, the scientific community describes the country as an "economic superstar" (Dustmann et al, 2014).

Except for the year 2000, when Germany marked the strongest economic performance since the unification boom (European Commission – EC, 2001), the first few years around the turn of the century were characterized by slow growth performances – as shown in the Graph 1 – leading to high and persistent unemployment and large budget deficits (as it will be illustrated bellow, in the Graph 2).

[2] While the North-Eastern countries were arguing for discipline and austerity, the Southern "camp" (Spain, Greece and Italy) was pleading for growth-oriented stimulus. But as the latter needed support from the wealthier EU member states (such as Germany), they emerged in a particular weak position.

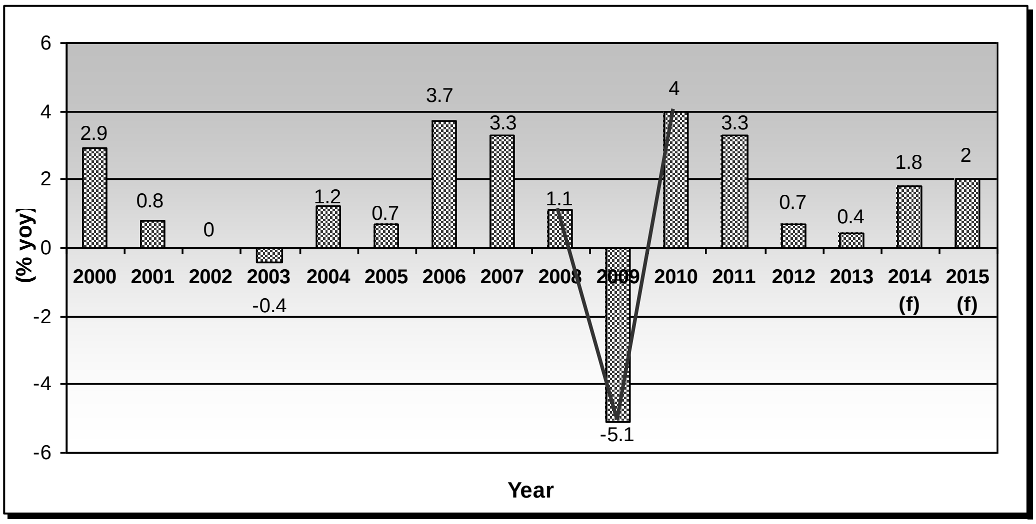
[3] France and Germany have driven European integration since 1950s (Guérot&Klau, 2012) and as the euro crisis has revealed, the political tandem was still functional nowadays. Hence, during the euro crisis, the most important partnership – "Merkozy" – has shown that the Franco-German team remains a vital driver of European governance.

[4] The label of "sick man of Europe" is traditionally attributed to a European country that is experiencing a time of economic difficulties. In the late 1990s, the economic press called Germany with this term as it was facing severe economic problems, especially due of the cost of German reunification after 1990 (see for instance The Economist, 2004).

[5] According to the economic literature, the term applies to the sharp decline in economic activity during the late 2000s that started in USA in 2007 and resulted in a global recession in 2009.

Graph 1: Germany's annual economic growth, 2000-2015∗

(Real GDP, % yoy)



Note: (∗) based on European Commissions' forecasts (f) for 2014 and 2015.
Source: Statistical Office of the EU – Eurostat (2014), European Commission – European Economic Forecast Winter 2014;

Consequently, Germany had lost its competitiveness and it was widely considered the economic laggard of EU. In this respect, in order to re-establish country's economic performance, to reduce its public deficit in line with the Stability Growth Pact's (SGP) requirement, to overhaul the labor market and to pave the way in regaining its traditional competitiveness, the federal government launched a very ambitious package of reforms and austerity measures (Agenda 2010[6]) that allowed German economic growth to rebound after 2005 (as it is shown in the Graph 1).

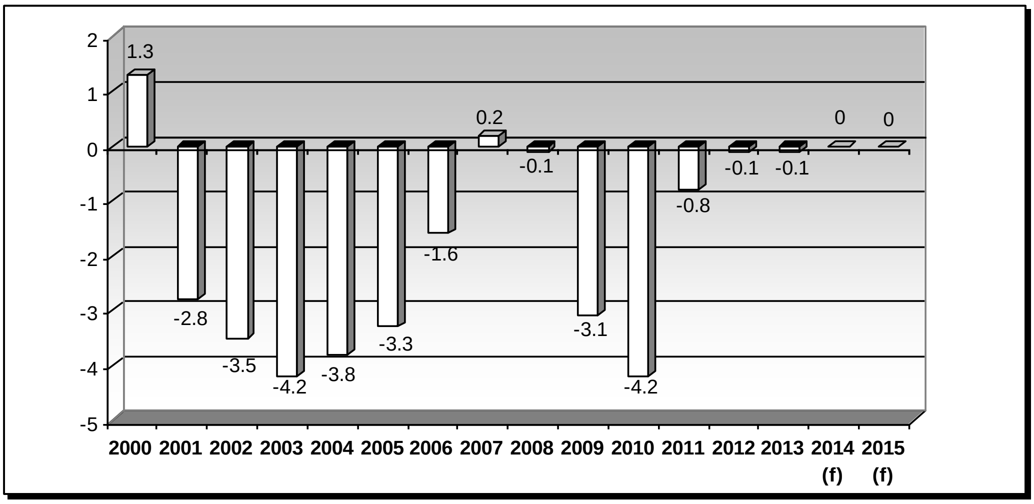
As a consequence of the reforms implemented during 2003-2005, German economy recovered in 2006 from its chronic stagnation and started to outperform again the rest of the European countries in terms of economic growth, employment creation and unemployment rate (Dullien, 2013). Moreover, the country strong economic performance at the time – supported as well by the strong expansion in the global economy, as Germany customarily had an export-led growth model – helped to consolidate public finances and the labor market, thus in 2007 the federal government budget was on a positive balance (as shown in the Graph 2) while unemployment, one the major problems the German economy was facing for many years, has already fallen significantly[7].

[6] The German Program "Agenda 2010" was initiated in March 2003, at the proposal of Gerhard Schroeder - Germany's Chancellor at that time.

[7] This positive trend was also due to the effect of the series of legislative labor market reforms, the so-called "Hartz reforms" that started in 2003 and came into effect in 2005, consisting in a package of radical measures that have helped Germany to drop unemployment, both on long and short-term.

Graph 2: Germany's government balance, 2000-2015∗

(As percentage of GDP)



Note: (∗) based on European Commissions' forecasts (f) for 2014 and 2015.
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However, the national economy's level of exposure to the external demand made it vulnerable to the extraneous shocks caused by the global recession in 2008-2009, albeit in the beginning Germany considered itself to be only marginally affected by the crisis (Dauderstädt, 2013). As an economy largely dependent on exports, with world trade dropping severely during the financial and economic crisis, Germany was heavily affected, as in 2009 its GDP declined dramatically, by more than 5% compared to the previous year. Howbeit, the economy recovered very quickly from what proved to be the worst recession in post-war history and the rebound of the economy in 2010-2011 was equally strong, resulting in a V-shaped recession, as it is illustrated in the Graph 1.

Although the federal fiscal stimulus program, adopted in 2009 and 2010 as a response to the economic decline has largely increased the national budget deficit in those years (as seen in Graph 2), German economic strategy was running short-term deficit to be followed by fiscal tightening after the economy has completely recovered. This plan was also supported by a strong manufacturing sector that helped the country to survive the global downturn (according to the World Bank (WB) data (WB, 2014), manufacturing's share of Germany's total GDP accounted on average 22% during 2009-12, comparing with a share of 10% in France and UK).

Thusly, by the end of 2011 Germany was back on the path it had followed since 2006 and as it seemed to overcome the crisis relatively undistracted, it was considered an economical miracle once again. Despite the steep decline in output, Germany was the only advanced economy in EU where unemployment decreased rather than increased during the crisis. This remarkable employment performance is reflected in the series of measures adopted by the government – first, the adjustments through lower working hours instead of layoffs and secondly, the government support of short-time work.

Furthermore, the negative impact of the sovereign debt crisis on the federal economy seemed to be limited so far, as Germany's outcome withstood remarkably well. As previously mentioned, it enjoyed a rapid rebound in 2010-2011, followed by a moderate growth in 2012-2013 and according to the latest forecasts of the European Commission (EC, 2014), amid reduced uncertainty, it is projected that Germany would improve its growth performance in 2014-2015 (Graph 1). Also, if until recently, the growth was largely driven by the external demand, in the aftermath of the crisis, notably since 2012, the upswing has become less dependent on exports, while domestic demand has became the key-driver.

Hereby, we may conclude that the fundamental lesson that Germany has learned during the path adopted in time of economic recession is that ambitious structural reforms to tackle the severe domestic problems may be harmful at first, but ultimately, they pay off. By acting accordingly, Germany not only recovered from the crises, but also became a model worth emulating, an anchor of stability in EU – stabilizing spillover effects for Europe as a whole – (IMF, 2013), as well as a decisive voice in the current debates related to EU's future architecture.

2.2. Germany's increasing role in the international arena

As stated in the literature in the field (SWP&GMF Report, 2013), the globalization reduced the power of national states and made the world smaller and more contested. Under these circumstances, we currently assist to a global power shift. The United States, conscious of its limited resources, is no longer willing to assume the role of global leader and guarantor of the international order on its own, while EU, which is still struggling with the severe consequences of the crisis, presently appears neither willing nor able to take on a similar position. Furthermore, the international engagement of individual European major countries has also declined significantly during the crisis. Thus, the result was a weaker leadership at the global level. In this context, Germany should see itself as a provider of further plans for organizing the adaptation to the new international order.

Currently, Germany benefits of an influential position and weightiness as it has joined the league of global players itself, which was not the case before the unification. If at that time the country lacked both the weight and the freedom of movement necessary for the development of strategic relations with partners beyond European and transatlantic framework, presently Germany's new power opens unique opportunities to use its influence and to reassess its international relationships and alliances. Moreover, as EU cannot have a strategic focus on the common European foreign policy without Germany's viewpoint, there were specific requests from European policymakers for a clear German commitment in this field. But until recently, Germany itself has lacked such a strategic focus (Guérot, 2013). Since the end of World War II, Germany has pursued a relatively tame foreign policy (Friedeman&Lanthemann, 2014), but the recent crisis in Ukraine marked a fundamental turning point in its international politics. German leaders have called for a new framework, opposite to the restrained policy that Germany has practiced for so long, which allows the country a stronger voice in the foreign affairs issues.

Besides, Germany's decision to undertake a more assertive external policy could be also justified by the necessity to find a new binding element in order to rally EU, as long as for the past six years, the economics proved to be rather a centripetal force.

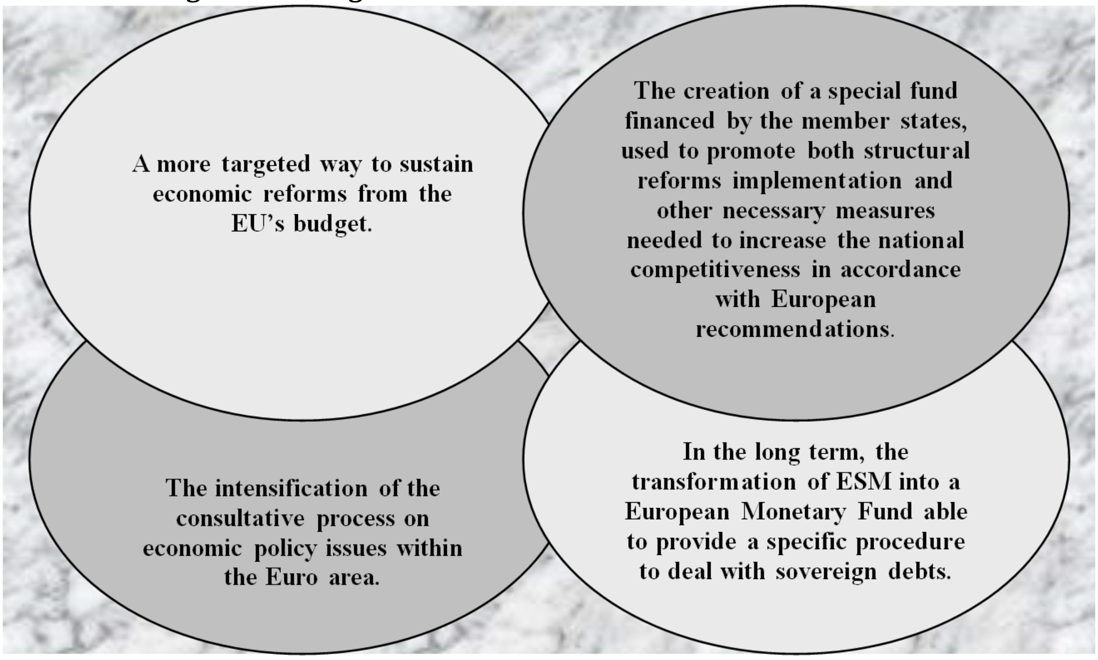
3. Where Does Germany Want To Take Eu?

The main goal of the German European policy is represented by the stabilization and further consolidation of the Eurozone. As the crisis has revealed, the economic and monetary policies of the EMU's member states cannot remain any longer a purely national concern, thus the monetary union must be supplemented by a true economic union and especially by a fiscal union. Besides the delicate task of elaborating and formulating fiscal and economic policies directed to achieve stability and competitiveness in the member states along with the acquirement of a greater convergence in the Eurozone, a major challenge is that the latter cannot be solely achieved by adjustments in the countries affected by the crisis. In this respect, Germany will focus on the promotion of EU wide consensus on common economic and financial policies that are supported by European public. Albeit the path to achieve these goals is still at issue, the main challenge remains the modality to readjust two delicate balances: between national autonomy and common European interest on one hand, and between institutional capacity to act and democratic responsibility, on the other. Consequently, even if the solutions can only be found together with all the European member states, German European policy must be able to provide suggestions and to draw specific frameworks in this respect.

Howbeit, the federal policy for EU envisages two potential models designed to reshape and reinforce EU's architecture, both intended to achieve a higher degree of integration together with a deeper democracy. The proposed models are not alternative as in fact they have the same objectives, but they differ only in terms of degree and depth of integration and also in the specific balance they strike between the intergovernmental level and supernational integration.

First model – a stronger European scheme for national reforms: this option is focusing on further fiscal consolidation and enhancing the competitiveness in all the member states by extending the dimension of the already adopted reforms. Hereby, in order to reform their economies and to return to a sustainable growth path, the European economies affected by the crisis need more support and incentives. For a suitable achievement of the reform process, while the national authorities will continue to maintain control over the mechanisms of the reforms, the European Commission would exert a greater role in the control of member countries' budgetary and fiscal policy. Accordingly, one prime model that Germany envisages in this respect is based on four main interconnected pillars, as illustrated in the Figure 1.

Figure 1: A heightened framework to sustain national reforms



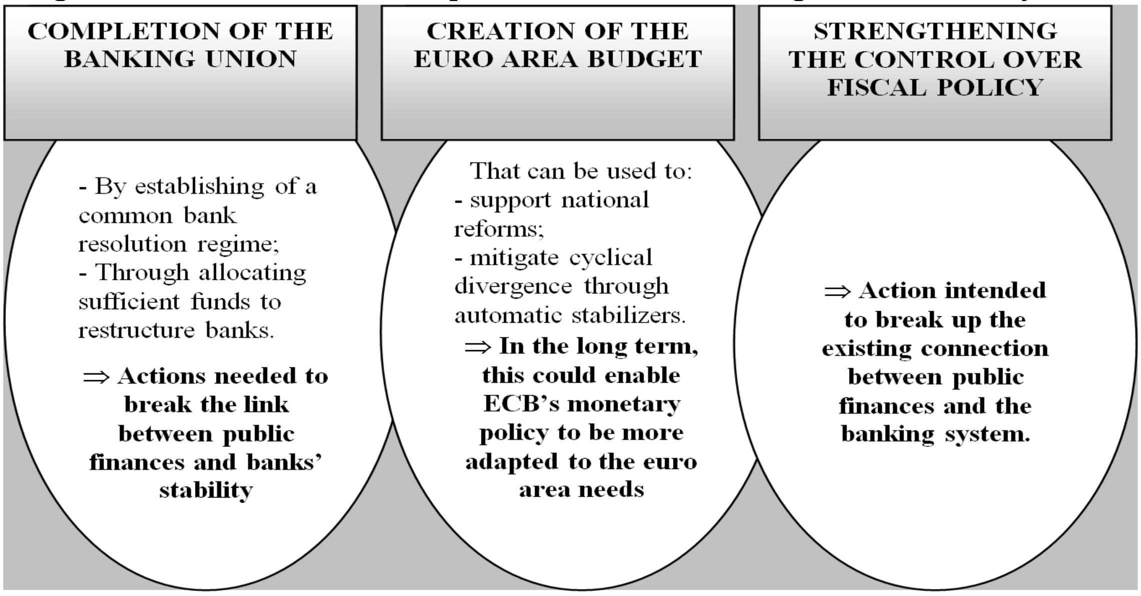
Source: Author's synthesis based on cited scientific literature.

As within the Eurozone complying with the debt limits set up by the SGP is of vital importance, the model developed and proposed by Germany requires also sanctions for the countries whose budgets repeatedly exceed the deficit limits set up by the Pact.

Second model – more common capacity to act on European level

Albeit the second option is conceived upon the stages toward a further integration developed into the first model, it represents a qualitative improvement. Thus, by taking into consideration the argument that the integration of monetary and financial markets restrains national capacities to act and thus make them vulnerable, it concludes that a policy convergent reform is not enough to stabilize euro area. In this respect, the model proposes further actions intended for the achievement of a greater integration but also directed toward to regain the ability to react and take control over the crisis. Based on three packages of measures (as illustrated in the Figure 2), the model is designed to make the monetary union less vulnerable in the long term.

Figure 2: Additional measures required to stabilize and strengthen the monetary union



Source: Author's synthesis based on cited scientific literature.

The both models are designed to increase the level of European integration and to pay a role in adopting common decision, as the German leadership is based on the principle of collaboration. In our opinion, the second model requiring the deepening of financial and fiscal integration is more appropriate for the whole progress of European integration and for sustaining a steady economic growth within EU in the future.

4. Why Is Germany Still Reluctant Into Taking The Lead?

As mentioned before, since the crisis has evolved, Germany has perhaps involuntary slipped into a new leadership role in the EMU. Accordingly, Germany has steadily outlined the Eurozone reform debate and set the pace for other member countries, in line with its ambitious consolidation agenda. Nevertheless, as some authors state (Little, 2013), although it assumed the leadership position during the Eurozone crisis, Germany seemed to be a reluctant ruler, as it has not sought this political role. In compliance with some analyses developed at European level (Economist, 2013), there are three main obstacles that interfere with Germany's will to take on this leadership. *Firstly* it is the historical burden – the reticence caused by the two World Wars that still conjure up bad memories. Bearing this in mind, many national policymakers argue that Germany should assume the position of an economic force which acts politically modest.

Secondly, there is a widespread opinion in Germany that one of the decisive causes of the Eurozone crisis was generated by the Southern countries' sluggishness and in this respect, an acceptable solution would lie in the adoption of a fiscally prudent policy, as in Germany. This is the reason why – *thirdly* – Germany accounts furthermore the potential effects of the moral hazard. According to this approach, a rapid reaction from Germany and other Northern creditors would fuel the Southern countries' unwilling to overcome their addiction to credit.

Hence, in order to assume a more dynamic leadership and to build a coherent vision for EU's future as well as to comply with the strategic demands of other member states, Germany needs to set up and to develop a strategic pattern at European level, designed to assure that all the member states act on the same frequency and for the common interest.

5. Conclusions

The German economy has weakened in the competitiveness field following the reunification major effort in the early 1990s and giving its reduced economic performance at the time – correlated with the constantly rising unemployment – during the first few years after the introduction of the euro it was broadly considered as the economic straggler of the EU. Nevertheless, by assuming the task of implementing structural reforms on the labor market, backed with severe spending restraints on public investment, federal government has helped the revival of the national economy in 2006. Although Germany's high reliance on exports made it vulnerable to the global demand downturn in 2008-2009, the country recovered quickly from the deep decline and the following recovery was strong as well. Since it seemed to have overcome the crisis relatively safe, by 2011 many European countries and policymakers began to see the German economy as a model. However, Germany's economic success does not automatically make it a blueprint for every EU's member country and consequently, the European leaders should rigorously analyze and determine which elements of the federal reforms could be applied at their national level, in order to increase productivity, output and employment without causing other potential disturbing effects on long term growth.

Hence, we may summarize by highlighting a key lesson that German economy has learned from the past decade's experience – implementing a radical structural reform plan may have been costly at first but ultimately, the plan has paid off. In other words, German austerity is responsible for German prosperity.

In the light of the great turbulences caused within Eurozone by the sovereign debt crisis and against the negative backdrop that followed, it has been necessary to improvise, creating out of nothing structures of immediate support for the most affected countries and undertaking further reforms of the regulatory and operating framework. In this respect, by having taken the responsibility in maintaining the cohesion in the Eurozone, the biggest EMU's economy – Germany – had a pivotal role.

Furthermore, as an actual major player in terms of economic policy at European level, Germany should accept the transfer of power and assume a more dynamic leadership role, required to sustain the long-term viability of the European integration. Accordingly, Germany must work to deepen European integration in order to enable EU to master the internal and external current and potential challenges. In this regard, German government shares the view that additional actions to reform EU's and EMU's architecture will lead to a more robust monetary union, able to withstand potential future crisis. Albeit significant progress has already been achieved toward this end, there is still room for further improvements.

As at present Germany is still reluctant to take the economic lead over EU, seeing itself rather as a leading role model than a power willing to lead, the future task for the next years should be the work on developing a common understanding of a key issue – a European wide mutually accepted strategic pattern, directed to stabilize and strengthen the EU and Eurozone.

Moreover, Germany should continue its path toward a greater and more pro-active engagement in foreign policy and security affairs as well as maintaining a permanent focus on geo-economic issues and acting more effectively to solve the current global cross-cutting questions.

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