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Should Ms Merkel ignore Europe?

US economist Fred Bergsten once said – this was before 9/11 – that US presidents typically spend the first half of their mandate dealing with their domestic agenda before they start being interested in global affairs. A major issue for Europe today is whether Ms Merkel should follow that pattern and concentrate on addressing the problems of the German economy before she even starts thinking about plans for Europe.

The logic of the argument is straightforward. Europe's economic woes, it is claimed, and especially those of the Euro Area, have little to do with the EU as such. They primarily result from the inability of Germany, France and Italy to address their domestic weaknesses. Reform their labour markets, fix their social security systems, redress their public finances, etc., it is argued, and the rest will follow. Plans for Europe are a distraction, and the best Ms Merkel can do for the EU is to concentrate on her homework.

There is much to praise in this emphasis on the economy. Prosperity is the EU's premier public good and failure to deliver it deeply undermines the legitimacy of European institutions. Citizens throughout the Union are not sure any more that membership of the EU has brought prosperity and well-being. When French and Dutch voters were asked to give their opinion on the reform of the EU machinery, they chose to express instead their dissatisfaction with its output. Economic recovery can do more for Europe than diplomatic gestures.

No one will deny, either, that blurring responsibilities does not help. German labour market and tax reforms, to take just two examples, belong to the remit of national authorities. Involving the EU where it has no competence is a recipe for frustration. There are undisputable benefits to a clear assignment of tasks.

The question is, how far should the logic of the argument be pushed? Can national policymakers really rely on the achievements of European integration, and invest their political capital elsewhere? Or do they need to bring responses to Europe's crisis? Can they separate the European agenda from the domestic one? More concretely, should projects for improving the functioning of the Euro Area be discussed again, or put aside? Those questions will soon be addressed to the new German government.

The EU at risk

Let us start with the state of the EU. After a successful enlargement in 2004, 2005 saw a largely ineffective attempt at reviving the so-called Lisbon strategy for reform and growth; a bitter rift over the Bolkestein directive aiming at securing a single market for services; the rejection of the draft constitution by France and the Netherlands; an inconclusive controversy over the EU budget; and a half-hearted opening of accession negotiations with Turkey.

Hopes that the crisis over the constitution would create a sense of common purpose and trigger a joint reaction by the European leaders have been dashed. What the crises have highlighted, instead, is the depth of the disagreements over the future and even the very purpose of the EU. In his speech to the European parliament on the eve of the UK presidency, Tony Blair emphasised openness and economic reform, but his country remains doubtful of the benefits of Europe and he has not been able to deliver a compromise for restructuring the EU budget. Jacques Chirac defends the vision of Europe as a shelter to protect citizens from the strains of globalisation, but France’s economic and social performance has dented his credibility. Further towards economic nationalism, members of Italy’s ruling coalition have openly questioned the virtues of the euro or of global trade opening, and Poland’s new government has expressed reluctance to accept foreign direct investment in some key sectors. There is a visible lack of unity and leadership, and the risk of a slow unravelling of the achievements of the last decades cannot be excluded any more.

This discussion does not primarily regard political integration. It is much more fundamentally about the purpose and effects of economic integration in the context of globalisation. In the French referendum campaign, very few discussions addressed the institutions and most were about free markets and the loss of jobs induced by global competition. Idiosyncrasies apart, the essential European debate today is the one Gordon Brown has launched: what are the meaning and purpose of the EU in an era of global economic integration?

Ms Merkel has a particular responsibility in this debate. She is not only the chancellor of the largest country, but also the representative of an upcoming generation of new leaders. Furthermore, as the economy which has best succeeded in restructuring its industrial structure to take benefit from the economic integration of Central and Eastern Europe and recoup its position as the world’s number one exporter, Germany has particular legitimacy to address the issue of globalisation in its relationship with European integration. The chancellor cannot afford not to exercise leadership.

Reliance on tradition?

Tradition, however, suggests European leadership does not need to impact domestic policy. German chancellors have generally dealt with domestic and European affairs in parallel, without creating much links between them. Unlike other countries like France and Italy, where domestic reforms (from disinflation and budgetary consolidation to market liberalisation) have generally been undertaken in the name of Europe, Germany has consistently been characterised by a quiet disconnect between domestic and European affairs. In a sort of detached commitment, it has succeeded in retaining leadership in Europe while mostly keeping EU issues in the diplomatic realm and avoiding interference with domestic policy and politics.

A major reason for this attitude was for long that Germany exported its own economic model to the rest of Europe. From the 1970s to the 1990s, reference to this genuine combination of microeconomic efficiency, macroeconomic stability and social responsibility was commonplace and many countries, West and East, strived to emulate it. Germany could afford being detached because it was the other member states' task to learn from it.

Today's situation does not conform to this pattern any more. Not only has Germany's economic and social model ceased being a model for the rest of Europe, but on a more fundamental level, there are two reasons why the usual disconnect does not work any more. The first has to do the links between European integration and domestic reform; and the second with the euro. Let us take them one by one.

Domestic reform and European integration

Once upon a time, things were clear. European integration was about the liberalisation of goods markets, and domestic policies dealt with labour markets or social protection. The separation was clear, and interdependence was minimal.

This is less and less the case as it is increasingly apparent that product markets and labour markets reforms are closely linked. Product market reforms that increase competition lose most of their efficiency if labour markets remain dysfunctional; conversely, the job creation effect of labour market reforms can be severely reduced if the structure of product markets discourages entry and entrepreneurship. There is therefore a high degree of economic complementarity between EU and national reforms.

There is also a political economy link between those reforms. Increased competition in product markets, for example through the dismantling of regulations preventing entry, destroys the economic rents that previously accrued to the oligopoly producers. In many sectors those rents are in fact shared between employers and employees. Destroying them therefore does not affect the firms only, but also their workers. This has led some scholars to advocate product markets reform as a precondition for successful labour market reform – because without the rents, resistance to change would be less. However, the linkage works both ways: those who oppose labour market reforms have a strong incentive to resist product market reforms also.

This helps explain the controversy over the services directive introduced last year by former commissioner Frits Bolkestein. From the risks of inefficient regulatory competition to social concerns, there are certainly reasons to discuss whether the directive is the appropriate instrument to create a single market for services. However, the crux of the issue is elsewhere. Opposition to the Bolkestein directive is not fundamentally about means, it is about ends. Significant segments of European opinion are unconvinced of the benefits of increased competition in this sector. They fear job losses and wage cuts and see the service sector as the ultimate shelter – and even more so in a more diverse and more open Europe.

There are however compelling reasons to create a single market for services. Europe's productivity drift in comparison with the US largely results from the now inferior performance of its service sector. Growth revival thus hinges on the ability of this sector to modernise and open up to new entrants. Furthermore, in response to the competitive pressure of emerging countries and in view of a possible appreciation vis-à-vis the dollar, European economies need to be able to shift to the service sector resources that have become idle in manufacturing. This, again, requires a more dynamic service economy supported by a pan-European single market.

Strong complementarities – and policy controversies – mean there would be little rationale for treating domestic and European reforms independently. The success of Ms Merkel's domestic reforms depends to a large extent on the fate of European initiatives – and vice-versa.

The euro effect

The second reason why the usual disconnect does not work any more is the euro. Although it has now been in place for five years, the extent to which it has changed the rules of the policy game in Europe has not yet been fully realised.

The ECB has been given the clear mandate to look after price stability in the Euro Area as a whole, and since its beginnings it has very consistently made clear that it is interested in the aggregate performance, not in that of individual countries. This implies that its interest rate policy reacts to the policies of an individual country only to the extent they affect the aggregate performance. For a small country like, say, Ireland, this amounts to saying that the ECB does not react to its policies at all. But even for Germany, the largest economy in the Euro Area, roughly one-third of the ECB's reaction depends on German performance and policies, and two thirds on those of the other countries participating in the single currency. This also means that its monetary conditions heavily depend on the behaviour of the partners. For example, a reform that increases Germany's growth potential can elicit a positive interest rate response from the ECB – but only in proportion to one-third of its effects. If, simultaneously, the other partners' policies go in the opposite direction, the effect is neutralised – or even reversed. The euro has thus created a powerful channel of interdependence among the countries participating in the single currency, and between their policies.

However, interdependence has not fully been matched by governance. The initial set-up emphasised just one category of spillovers, those arising from excessive deficits in a member country, and attempted to deal with them through fixed, quasi-automatic rules. Gradually, participants in the euro have come to realise that this was neither enough nor adequate. What they have begun to put in place with the reform of the Stability and Growth Pact is a more elaborate system that blends rules with joint decision. But such a system can only work to the extent it is supported by political commitment and an effective governance structure. The fixed presidency of the Eurogroup is a step in this direction, but no more than a step.

A test is looming. The coalition has decided to give priority to budgetary consolidation. This first means that there should again be ownership in the Stability and Growth Pact, that child of German budgetary discipline, which had remained orphan for years. Such ownership is a key condition for the effectiveness of a decision-based governance regime.

But there is more to this test. The German adjustment is bound to have significant effects on the partner countries.

In the first five years since the introduction of the single currency, Germany contributed one-fourth to output growth in the area and only 10% to internal demand. It has thus been a drag on overall growth. Most of its own growth has been fuelled by external demand, including from the other countries in the Euro Area: in 2004, it had a €85bn trade surplus with them. There have certainly been good reasons for that. Having entered the euro at a relatively high exchange rate, the German economy needed to restore its competitiveness vis-à-vis the rest of the Euro Area. To this end, companies have cut costs, improved productivity and delocalised the segments of the value chain for which German location had become uncompetitive. This has been a long and painful process, a necessary one, and a successful one. But Germany's partners now expect recovery in its domestic demand.

The choice of giving priority to budgetary adjustment means they will have to wait longer. An abrupt increase in the VAT rate should depress German consumption in 2007. Confronted with lower demand across the border and lower labour costs in Germany (as a consequence of the cut in social security contributions), other countries in the Euro Area might suffer – especially those, like Italy, who are already experiencing high labour costs and low competitiveness. This would further increase the already significant imbalances and divergence within the Euro Area – and put its internal functioning to the test.

This is certainly not an inevitable consequence. Some countries have experienced expansionary budgetary consolidations. But this was more frequently after having cut spending rather than increased taxes, and in a context where they could count on monetary support. In order for the German consolidation not to depress internal demand, the coalition government will need to create confidence in its strategy and probably also help offset the rise in consumption prices by a liberalisation of credit markets.

Whatever the outcome, the pace of the German adjustment and the degree to which the effects of the tax hike will be offset by other sources of domestic – and not only external – demand is not a purely domestic question. It is an issue for the Euro Area as a whole. Being a large economy, Germany cannot simply overlook the consequences of its policy on its neighbours. This is another reason why Ms Merkel cannot really afford to ignore Europe.