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Macron a Game Changer for Europe?

The election of the youthful Emmanuel Macron as President of France has re-awakened the hope that the European Union could finally start moving forward again. Reforming the euro area seems an obvious first step. However, this might be more difficult than commonly anticipated. Much has been made of the prospect of a new era of Franco-German leadership. However, the German part of it is unlikely to change. Moreover, France and Germany can only lead if other member states are prepared to follow. This might be much less likely than widely assumed.

The first key element is thus that one half of the Franco-German "couple" has not changed. Germany is likely to retain its chancellor after the elections later this year. Moreover, Germany's interests and its perception of the EU's problems have not changed. This Franco-German discord was already visible a quarter of a century ago, when the foundations for the euro were laid in the Maastricht Treaty. At the time, the main problem was how to tame inflation. The German solution, supported by the consensus of the academic research, was to create an independent central bank and task it with maintaining price stability. France was able to agree to this approach because it would get a seat on the board of the proposed European Central Bank (ECB). To ensure that unstable public finance would not create pressure on the ECB to conduct lax monetary policy, the Maastricht Treaty also contained limits on deficits and debts, which were later enshrined in the Stability and Growth Pact (SGP). These fiscal rules appeared, at the time, to be of limited relevance for France, since French fiscal policy had traditionally been quite prudent. Moreover, the enforcement of the SGP was ultimately left to political decisions.

Today, the key issue is no longer high inflation, but rather financial stability. This is mostly due to high levels of debt, meanwhile the ECB is fighting to prevent inflation from remaining too low. But there is no consensus on how best to maintain financial stability and whether low inflation is really a problem. Germany, as a creditor, does not regard low inflation as a major concern, and it would like to create a framework under which the debtors will service their debt.

It is thus not a surprise that Germany has remained the champion of a rules-based system which emphasises the need to keep deficits low and one's house in order. France, on the other hand, has different interests, and it sees the need for the state to have its hands free to intervene when needed, which sometimes might justify deficits and bailouts in order to prevent crisis. Moreover, France does not have the same creditor position as Germany, and its relatively weak economy has resulted in continuing deficits and rising public debt levels. Consequently, it is now much more difficult to find a grand bargain between these two core nations of the EU.

That being said, both countries realise that maintaining financial stability is the primary challenge facing the euro area. There is no longer any need for emergency action, as financial market tensions have subsided, while the euro area economy is expanding as employment returns to its pre-crisis peak. However, this calm might be only temporary, due to the large bond-buying programme of the ECB. France, with its large banks, should understand the urgent need to complete the banking union. Some Franco-German cooperation should thus be possible in this area.

Actually, the main impediment to the banking union is likely to lie elsewhere. The missing element of the banking union is deposit insurance, which remains a purely national

responsibility. However, in German eyes, a common deposit insurance is not compatible with the current practice of banks to hold very large amounts of their own government's debt. An insolvency of the sovereign would bankrupt the banks, with the costs to be borne by the entire euro area. France might not object too strongly to this point of view, given the high rating of its own sovereign debt. But Italy might find it very difficult to agree to limits on sovereign bond holdings, because it fears that its funding costs might skyrocket if Italian banks are no longer allowed to buy a large proportion of its debt. The one clear step to complete the banking union thus needs an Italo-German agreement much more than a Franco-German one.

An even more fundamental disagreement is likely to arise regarding a second key issue, namely the use of fiscal policy to sustain demand at the euro area level. From the German perspective, recent years have shown that eliminating fiscal deficits is good for the economy in the long run. France and Italy see it differently: to them, Germany has been able to achieve surpluses because it has engaged in competitive wage restraint while the others have sustained demand with their own deficits. Their argument is that not everybody can run huge external surpluses and that the euro area would remain mired in deflation and low growth if everybody tried to follow the German example.

These different views of the world make another grand bargain unlikely. France is likely to insist on some mechanism to sustain demand at the euro area level, but Germany is unlikely to see the need for this. In the context of a wider political bargain, it is possible that Berlin could consider some form of a small budget for the euro area for investment purposes, especially if Macron shows that he will ensure the long-term solidity of France's public finances. A German concession on this front would strengthen Macron's position, but a euro area budget focused on investment would necessarily remain very limited and unlikely to have a macroeconomic impact, as even France might balk at transferring a large portion of its own tax revenues to a euro area authority which it could not control. Over the last 20 years, successive French governments have made vague proposals for a "*government économique*" of the euro area, but these proposals were never meant to limit the freedom of manoeuvre for the French government itself.

In this area, again, Italy might represent a bigger problem than France. It is difficult to imagine greater fiscal integration as long as one large member state has such a weak combination of high debt and low growth.

For all these reasons, it is unlikely that the election of Macron will be a game changer for the euro area. Moreover, as the ongoing recovery of the euro strengthens, the perceived urgency to complete the banking union and create mechanisms to manage demand at the euro area level will only diminish. If Macron wants to leave his mark on the European scene, he must realise that political and economic stability at home are a pre-condition for progress on European issues. The success of Macron's domestic reform programme will thus be more important than his Europhile credentials, as only with domestic success will France truly be able to stand side-by-side with Germany and usher in a grand alliance of the two largest economies in Europe – an alliance that could truly achieve real progress for the European Union in the coming years.

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