COMMENTARY

Thinking ahead for Europe

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Europe's new hope?

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The prospect that the centrist, pro-European Emmanuel Macron will become the next French president has fuelled hope that renewed Franco-German leadership of the European Union may be on the horizon. After Germany's general election in September, it is hoped that a more stable EU could begin to make much faster progress towards unity and integration.

To that end, reforming the eurozone seems an obvious first step – one that Macron himself often brings up. But this might be more difficult than anticipated. For one thing, there are deep differences between the economic philosophies of policymakers in France and Germany.

As Markus K. Brunnermeier, Harold James and Jean-Pierre Landau explain in their recent book, Germany has become the champion of a rules-based system that emphasises keeping deficits low and generally prohibits bailing out debtors. France, by contrast, tends to support the idea that the state should be free to intervene when needed, running a deficit or even providing a bailout to prevent a crisis. Fortunately, Macron's programme recognises elements of the German approach, such as the need to balance the budget in the long term, which suggests that, under his leadership, a Franco-German compromise might be possible.

Of course, the differences between France and Germany extend beyond economic philosophy, to actual performance. But even those differences may not pose an insurmountable obstacle to cooperation.

While much has been made of the weaknesses in the French economy, in many ways, France represents the eurozone average. Its growth rate has been about half a percentage point lower than Germany's over the last few years. But this is now changing, and France's potential future growth is about half a percentage point *higher* than that of Germany, where the population is shrinking.

Moreover, France's unemployment rate is declining, although it remains much higher than Germany's. Likewise, while France's public finances do represent a problem, the debt level is on a downward path, and Macron's programme recognises the need to reduce spending, in order to enable tax cuts.

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In this context, a Franco-German initiative on eurozone reform may well be possible. If it is, what could be done to shore up the monetary union?

As it stands, there is no longer any need for emergency action. Financial-market tensions have subsided, and the economy is expanding, with employment returning to its pre-crisis peak. So the policy focus would be on long-term reforms.

Such an agenda should include the completion of the banking union, with the strengthening of common deposit insurance. The challenge here lies in the fact that common deposit insurance is incompatible with banks' current practice of holding very large amounts of their own government's debt. If the government becomes insolvent, crashing the banks, the costs would be borne by the entire eurozone.

Here, the dispute is not between Germany and France, but between Germany and Italy. Germany has insisted that, without limits on the amount of government debt banks can hold, no common deposit insurance can be introduced. But Italy has objected to such limits, fearing that government funding costs might skyrocket, and perhaps also that its own banks, which depend financially on the higher interest earnings of their holdings of public debt, might suffer deeply.

Italy represents the sticking point for Germany on debt mutualisation as well. The Germans have enough faith in France's long-term economic stability to consider some kind of small budget for the eurozone. But when it comes to Italy – with its combination of high debt and sluggish growth – Germany has no such confidence. This reservation represents the biggest obstacle to further fiscal integration in the eurozone.

There is another area where the problem concerns Germany and Italy more than Germany and France: the management of refugee flows and the distribution of asylum-seekers. To be sure, the EU's 2015 deal with Turkey, combined with the closure of the Balkan route in the spring of 2016, has reduced the number of refugees reaching the EU from the southeast to a mere trickle.

But thousands continue to arrive from the south, crossing the Mediterranean. And as the conflict in Libya intensifies, these flows threaten to increase. At the moment, those picked up in the Mediterranean are brought to the nearest ports, which just happen to be in Italy. Under the so-called Dublin rules, Italy is then responsible for taking care of them, providing them with humanitarian support and processing their asylum applications, which number in the hundreds of thousands.

For many of those asylum-seekers, however, Germany is the real goal. The German government knows that, and recognises that it cannot simply hide behind the Dublin rules. Both Italy and Germany thus have a strong interest in finding a European approach, one that strengthens the EU's capacity to guard its external borders, perhaps via a European Coast Guard, while distributing the burden of accepting refugees more equitably across the Union.

France has so far not been active in this discussion. After all, its main problem is not immigration, but rather the integration of the second generation of immigrants – and the extremism that failure on that front can foment.

Yet the next French president should take a more active role. Package deals are a specialty of the EU, and Macron should not concentrate exclusively on the euro agenda. Instead, he should take into account the priorities of both Italy and Germany. That means putting together a package that responds to Germany's priorities – namely, ensuring fiscal stability and securing limits on bank holdings of sovereign debt – while helping to ease the burden on Italy of guarding the EU's external border and admitting refugees. With such an approach, perhaps 2017 really can become a turning point for Europe.