



Packed European agenda for the next government

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Numerous challenges, no (easy) answers

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The now more benign economic and public environment in the EU allows it to fundamentally address shortcomings of the E(M)U. The current backlash of populism, rising public support for the European project and the pick-up in the economy give politics more leeway to foster the debate on institutional and policy reforms.

The next German government's term is faced with numerous challenges that might turn into political risks for Europe and thus require sensible management: (i) A deal on Brexit and future EU-UK relations (ii) negotiating the post-Brexit budget (iii) coping with the migration flows (iv) overhauling the framework of the euro area (EA) including Banking Union and institutional questions. Improving the EU's economic performance and coherence should be self-evident, though.

A revitalised relationship with France offers Germany the chance to mitigate the unwanted and unintended label of the "European hegemon". It provides an opportunity for substantive steps to further stabilise the EA albeit Germany and France need to find common ground on many issues and seek the support of the other member states. The concept of a multi-speed Europe might be an option to move ahead with the EA but it has disadvantages in other regards. Balancing (financial) solidarity with (fiscal) solidity and (reform) conditionality will remain essential for selling changes in the EA to the German public.

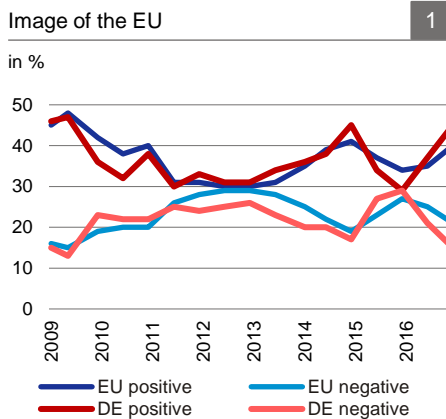
European policy issues are still less of a topic for the German electorate. Reflecting the general attitude of the German public, mainstream parties are all various shades of pro-European. Both CDU/CSU and SPD are supporting a broader and deeper upgrade of the EA architecture but election manifestos differ in scope of commitment and level of detail. The Liberals call for a strengthening of the fiscal framework, e.g. an insolvency regime for the EA whereas SPD and Greens favour a deeper social union and further initiatives for EU-wide investment. An EU migration policy or more cooperation in home and security affairs are common features in the parties' positions.

The next government's composition is likely to impact on Germany's European policy course. While there is a general political mood to move forward just how much will depend on the partners in the government. The appetite for ambitious reforms of the EU might be larger in another CDU/CSU/SPD coalition given the overlap of their positions. A conservative-liberal coalition will not refrain from reforms but might alter both speed and scope of them.

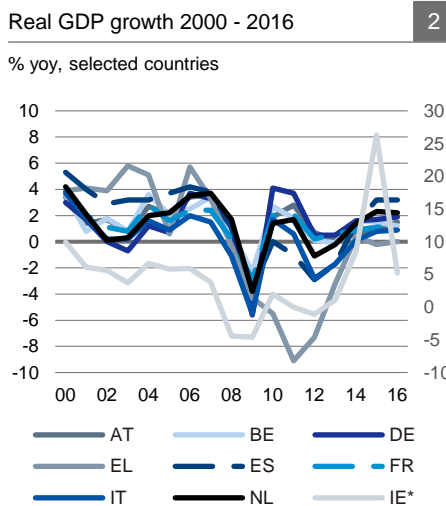
An important signpost could be the German EU presidency in 2020. Most of the proposals for the evolution of E(M)U require complex agreements or even changes to the EU Treaties as they would involve further loss of sovereignty. During its last presidency in 2007 Germany paved the way for the Lisbon Treaty. Given the need for referenda in some member states, though, any treaty changes in this respect remain a difficult endeavour in the by then EU-27.



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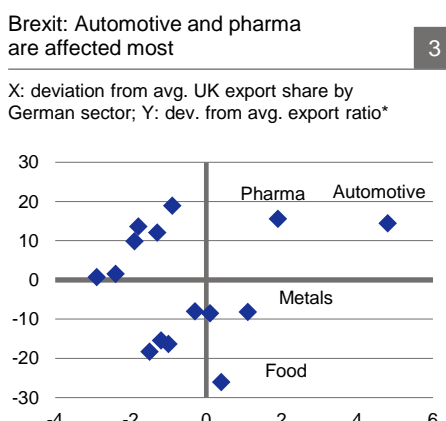


Sources: Eurobarometer, Deutsche Bank Research



* IE right axis

Sources: Eurostat, Deutsche Bank Research



* Deviation in percentage points in each case, 2016

Sources: Federal Statistical Office, Deutsche Bank Research

Over the last twelve months sentiment in Europe has improved significantly. Growth expectations have brightened and broadened with DB Research now expecting GDP growth of 1.9 and 1.6% for the euro area (EA) in 2017/ 2018. Eurosceptical populism has experienced a significant backlash reflected in the election outcomes in the Netherlands and France. Support for the EU, which has dipped significantly in the course of the euro crisis, has recovered and received a further (unexpected) positive push in the aftermath of the Brexit vote.

Germany has been an outlier over the recent past both in terms of economic development – growing above potential for the fourth consecutive year – as well as continued public support for European integration and the euro. The four-year old eurosceptical party AfD saw its peak during the refugee crisis and is now hovering around 8% in the polls – enough to enter the Bundestag but far behind the importance of eurosceptical movements in other European countries. The combination of economic strength, in particular to the other EA members, and political stability has put Germany in a pivotal position – though Germany remains cautious about assuming clear leadership.

Brexit – managing a lose-lose situation

The Brexit decision has significant political and economic repercussions for Germany. The UK has been a strong ally in pushing for open markets and less regulations. There is the concern that without this heavyweight the group of market liberal member states might lose out to a more interventionist or even protectionist policy development in the EU. Further, the UK is Germany's third largest export market (7.1% of exports in 2016) with particular relevance for automotive and pharmaceuticals (see chart 3). The strong export exposure has fuelled the perception by many observers that the German government would follow a rather accommodative stance in Brexit negotiations and pressure EU partners to follow suit. But, the German government made clear from the outset that the unity of the single market with its four pillars needs to be observed. This position has not only been consensus among the EU-27 and has formed the policy orientations for the EC Brexit Task Force.¹ It is shared by the German broader public and the business sector as well with the latter pointing to the fact that a post-Brexit single market would still account for more than 50% of German trade.

However, agreeing on the terms of a transitional period after March 2019 and working towards a broad trade and investment agreement for the future should be in mutual interest. Art. 50 TEU talks are under way focusing on the citizens' rights, the UK's financial liabilities and the North-Ireland topic in the first round. The financial settlement where positions significantly differ (the UK government has only recently officially acknowledged that it has financial obligations in the course of Brexit and possibly beyond) is a particularly crucial one. This is of significant relevance also for Germany as the largest net contributor to the EU-budget – but significant differences also continue on the legal framework to enforce the terms of a settlement, i.e. the role of the ECJ or some sort of dispute body. On the recommendation of the EU's chief negotiator, Michel Barnier, EU member states will decide if enough progress has been made to start tentative talks on the future trade relationship and the related questions about a transition period. If talks advance, this decision could be taken as early as at the EU 19-20 October summit or else in December. The timeline is tight and any new German government will have to take into consideration the risk of a hard Brexit, i.e. a failure to agree on a sensible transition deal to bridge the couple of years until a final trade and investment agreement is in place.

¹ See the detailed negotiation documents of the EU Art. 50 Task Force https://ec.europa.eu/info/departments/taskforce-article-50-negotiations-united-kingdom_en#negotiationdocuments

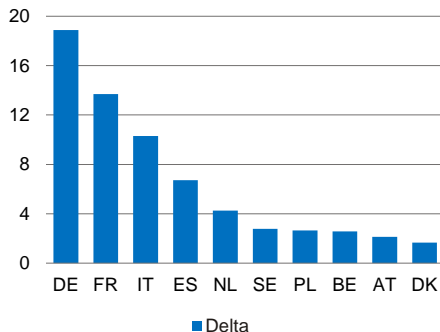


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EU budget: Who's to pay for Brexit?

4

Additional annual payments in EUR 100 m,
0.06% of each member state's GDP



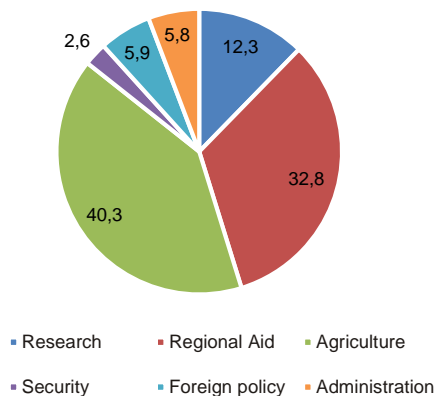
Calculation based on average data 2014-2015

Sources: Eurostat, EC, Deutsche Bank Research

EU budget by sector 2016

5

in %



Sources: European Commission, Deutsche Bank Research

Fierce negotiations over next Multiannual Financial Framework 2020-2027

The withdrawal of the UK will have significant ramifications for the next EU budget period and will likely make negotiations even more difficult than they have proved to be in the past. Whatever transitional arrangements foresee, the missing British contributions (EUR 15.1bn in the first two years of the 2014-2020 budget) will either require higher contributions by net contributors, a cut in transfers to net recipients or a combination of both.² In fact, such a numeric approach would fall short of adjusting the EU finances to a rapidly changing global environment, give the budget a more growth-oriented structure and provide it with transparent financing rules. In its Reflection Paper on the Future of EU Finances (June 2017), the EU Commission sets out a number of more fundamental questions that should give orientation to the reform debate: What should the budget be used for? Where is the best value for money in terms of European public goods and expectations of the European people? How should the budget be financed, e.g. by new own resources? Would new tasks in the context of migration or external border control require additional funding or would a re-allocation of funds according to the future priorities be sufficient?

While there is a broad discussion around this topic among academics and in institutions³, the political debate has not really started yet. The next government will be faced with expectations that Germany should pick up a larger part of the bill given its economic strength and fiscal leeway. These demands positively resound with SPD Chancellor candidate, Martin Schulz. The Finance Ministry in its latest monthly report, however, argues to adjust funds to the changed priorities and keep the current cap to the budget volume of 1% of EU GNP.⁴ It also suggests to link transfers from EU-Funds to the implementation of the country-specific recommendations in the framework of the European Semester. An even broader approach includes demands to make transfers from the EU budget dependent on compliance with the (democratic) values and rights of the EU or solidarity in the context of joint decisions in policy areas such as migration.⁵ These questions will lead to a heated debate and it cannot be ruled out that the budget issue will only be settled at the eleventh hour under German EU presidency in H2/2020.

Migration topic highlights strong linkage of national and EU policies

According to German (ZDF Politbarometer) and European (Eurobarometer) surveys concerns over the flow of refugees and migration rank high and are seen as a task urgently requiring a European answer. This reflects the fact that the migration crisis still lingers not least with regard to the mounting uncertainties related to the EU-Turkey deal. In H1 2017 102,847 refugees and migrants have arrived in the Mediterranean area. More than 80% of these immigrants came to Italy followed by Spain and Greece with 9.2% respectively. This contrasts with the situation in H1 2016 when Greece reported the largest figure of entries by far (158,400 persons, Italy 70,222).

The substantial (94%) reduction in the number of refugees in Greece shows that, together with the closure of the Balkan route, the EU-Turkey agreement works. The controversial agreement is far from perfect but it appears a second best solution for the problem. Thus the focus has now turned to Italy. Recently,

² Böttcher, B.; Rosenberger, L. (2016): EU budget: Who's to pay for Brexit?

³ There is a broad discussion of necessary reforms incl. EU institutions. See for example: European Court of Auditors (2016): EU budget: time to reform?; Monti report on EU own resources (2016); Becker, Peter (2017): The right moment to reform the EU Budget

⁴ <http://www.bundesfinanzministerium.de/Monatsberichte/2017/07/Inhalte/Kapitel-3-Analysen/3-3-Haushalt-Europa.html>

⁵ SPD Chancellor candidate Schulz in his "Zukunftsplan" and in an interview with the Schwäbische Zeitung July 19, 2017

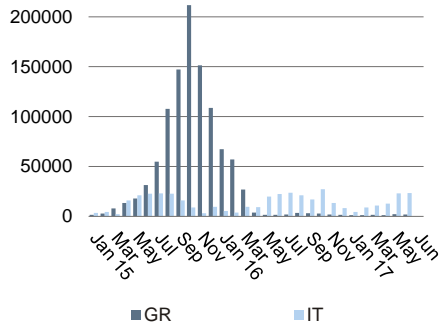


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Sea arrivals in Italy and Greece

6

Refugees and migrants



Sources: UNHCR, Deutsche Bank Research

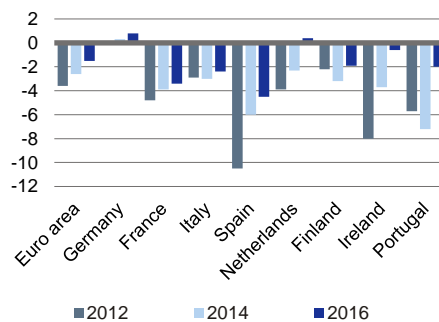
the Commission reaffirmed its strategy to reduce pressure stemming from the central Mediterranean route and announced some measures to support Italy. Coming to an agreement with certain African countries aiming to reduce incentives for migrants to come to Europe is a key element of this strategy, also put forward by the German government and endorsed in the CDU election manifesto. Germany is interested in the success of these policies as managing the number of refugees is precondition for successful integration here.

With reference to the situation in Italy, Martin Schulz recently warned of a renewed surge in migration to Germany similar to the influx in autumn 2015 when more than 600,000 people immigrated within a few months (H1 2017: 83,000). Schulz argued for more solidarity with Italy and stressed that all member states should participate in the refugee relocation and take in a fair share of refugees. In addition, the SPD frontrunner criticised Chancellor Merkel for her single-handed asylum policy at that time when she agreed to open the German borders for Syrian refugees without informing EU partners.

Fiscal Balance

7

% of GDP (selected countries)



Sources: Eurostat, Deutsche Bank Research

Martin Schulz' comment came a few days ahead of the ECJ which ruled, in a nutshell, that even in (the then) exceptional situation the responsible member state to examine asylum applications was the one where a person first entered the EU, i.e. that the Dublin Regulation was not suspended then. However, Germany was right to take responsibility for humanitarian reasons and as an act of solidarity with partner countries. While the German government and the CDU/CSU continue to put the focus on the administration of the Dublin Regulation, the SPD stresses the risk of administrative overload of front line states and calls for a better burden sharing.

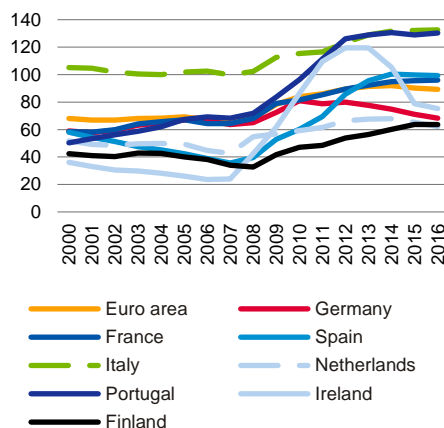
Evolution of the euro area

During the euro crisis and the following years significant measures to reform the euro area have been undertaken covering both legislative as well as institutional steps: The Fiscal Compact and the Two- and Six-Pack in the framework of the European Semester aimed at more sustainable public finances, the European Stability Mechanism (ESM) established a permanent solidarity tool for countries and banks with temporary problems, the Banking Union with the Single Supervisory Mechanism and the Single Resolution Mechanism should improve solidity of the banking sector with a level playing field.

Public Debt (selected countries)

8

in % of GDP



Sources: Eurostat, Deutsche Bank Research

Despite progress in the recent years, though, monetary and financial union in some regards remains in an unsustainable equilibrium with a common monetary policy and only limited instruments for shaping fiscal policy. Jens Weidmann, President of the Bundesbank, and François Villeroy de Galhau, Governor of Banque de France, called it the "asymmetry between national sovereignty and common solidarity"⁶. So far, there is no political consensus on the way forward and the extent of change needed, though. Put simply, the discussion is characterised by two lines of arguments around the interplay between solidarity and responsibility as well as risk sharing and risk reduction. The more decentralised approach emphasises the strict compliance with the preventive and corrective fiscal rules, the bail-out clause and consequent (national) risk reduction. It criticises that despite the experience during the euro crisis compliance with the – arguably very complex – rules continues to be low and flexibility has been overly stretched.⁷ Fiscal consolidation, if happening at all, has been driven above all by the ECB's low interest environment, i.e. allowing

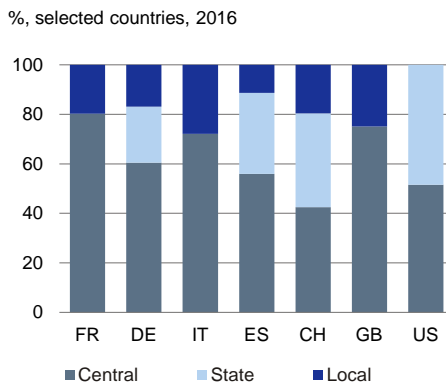
⁶ François Villeroy de Galhau, Governor of Banque de France (2017), quoted in European Commission (2017): About the Brussels Economic Forum 2017

⁷ According to the Deutsche Bundesbank, the deficit ration has been in excess of the 3% in more than 40% of cases and the debt ratio was below 60% in less than half of the cases since the start of EMU. Monthly Report June 2017: Design and implementation of the European fiscal rules



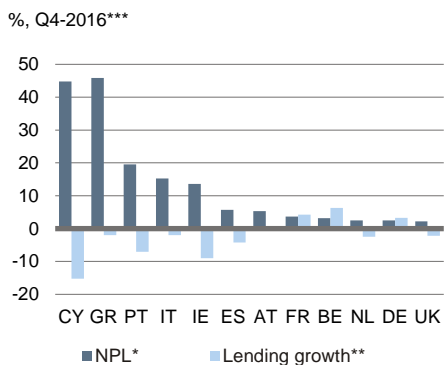
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Public spending by government level 9



Sources: OECD, Deutsche Bank Research

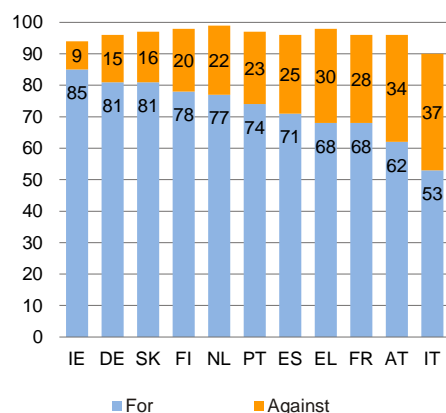
NPLs lead anemic lending 10



* NPLs as % of gross loans
** yoy lending to non-financial corporations
*** NPLs for the UK Q2-16

Sources: EBA, ECB, Deutsche Bank Research

Popular opinion on the single currency 11



Sources: Eurobarometer Spring 2017, Deutsche Bank Research

for lower debt servicing, while public debt levels remain high (see chart 8). The other approach favours a fully-fledged fiscal union with more discretion, central fiscal stabilisation function and the introduction of common risk-sharing instruments both public and private. Its supporters refer to countries with federal structures that have equalisation and transfer systems to eliminate regional disparities and effective stabilisation in case of asymmetric shocks.⁸ Rather than an either-or thinking, a balanced approach that combines obeying to the rules and incorporate some elements of a fiscal union appears appropriate to deal with the EA architecture's shortcomings. This is also reflected in the parties' election manifestos albeit different priority settings.

EU Commission's Reflection Paper proposes roadmap ...

The coming years are likely to see a more determined discussion on the economic and institutional balance in the EA probably also helped by the fact that average support for the common currency has recovered and stands at a very high level in a number of EA countries incl. Germany (Spring 2017 Eurobarometer survey, chart 11). As a comprehensive framework for debate – though not containing groundbreaking new ideas – the EU Commission has published its Reflection Paper on the deepening of the Economic and Monetary Union this May.⁹

For the short term, the Commission sets out agenda points that are work in progress. In particular, the Commission calls for a rapid agreement on the third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS) by 2019. While in academics there seems to be a broad support for a common EDIS¹⁰, there are also critical voices¹¹ highlighting the necessity of harmonisation of national insurance schemes as a prerequisite and emphasising the risk of setting wrong incentives through joint liabilities. Sequencing and timing of EDIS implementation thus remains crucial as is emphasised by all major German parties. The latest developments in the Italian banking sector have also resulted in cross-party calls to close (legal) loopholes in the resolution and bail-in rules for banks as well as to speed up tackling the problems of NPLs. Some of these legacy concerns also influence the approach towards the quick setting up of a common fiscal backstop to the Single Resolution Fund, despite the EcoFin already having approved the respective roadmap for Banking Union from June 2016.

... and sets out ambitious and controversial proposals for the medium term

For the medium term, i.e. post the 2019 elections to the European Parliament the Commission calls for the establishment of a macroeconomic stabilisation function or, relatedly, a euro area budget. Two main proposals under discussion are the creation of a European Investment Protection Scheme (meant to mitigate the shortfall of public investment in an economic downturn and prevent an amplification of the crisis) and/or a European Unemployment Insurance Scheme (as a complementary instrument to protect national social safety nets during downturns and warrant their function as automatic stabilizers). Access to both funds would be conditional on compliance with EU fiscal rules and other criteria and permanent transfers should be avoided. However, past evidence of member states' compliance with fiscal rules and policy recommendations by the EU Commission tend to cast shadows over this conditionality necessary to avoid

⁸ For an overview of the related debate: Vetter, Stefan (2013): Do all roads lead to fiscal union?

⁹ For a deeper assessment of the paper see contribution to Focus Europe: EMU reflection paper – mere „wish list“ or plausible way forward?, Deutsche Bank 9 June, 2017

¹⁰ IMF Staff Discussion Note (2013): A Banking Union for the Euro Area

¹¹ Deutscher Bankenverband (2017). Dossier Europäische Bankenunion



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ESM key facts 12

Legal structure	Permanent intergovernmental institution under public international law
Governance structure (highest level)	Board of Governors chaired by the president of the Eurogroup (euro area finance ministers) Decisions are taken by qualified majority, unless otherwise stated by the ESM Treaty
Capital structure	Authorised capital stock of EUR 704.8 bn: EUR 80.5 bn paid-in capital EUR 624.3 bn committed callable capital
Max. lending capacity	EUR 500 bn
Amount of assistance disbursed	EUR 68 bn

Sources: ESM, Deutsche Bank Research

moral hazard in the current set-up. Commission proposals for financing such instruments reach from using existing tools, the EU budget or the creation of a new rule-based instrument for national contributions (e.g. GDP-weighted). Funding will indeed be one of the crucial questions. Having a European fiscal mechanism only makes sense if it is powerful enough to provide support also to a fairly large country – or a group of countries – while at the same time those paying into the system must not be unreasonably burdened. Also, the paper proposes joint debt instruments, so-called European safe assets, and a change in the regulatory treatment of sovereign bonds both aimed at reducing the nexus between bank and sovereign risk.

Far-reaching proposals for a fiscal union would mean a major departure from the current European framework. Therefore, every step in the direction of a fiscal capacity of whatever nature would likely require a strong supervisory authority that is not only able to prevail over opportunistic governments but also able to exert influence on negative structural developments in individual countries. In the end, this describes the role of a euro area treasury with a finance minister as mentioned in the Commission's paper and promoted by the French president.¹²

However, the willingness of member states for such a significant transfer of sovereignty – independent of economic considerations – is more than questionable and would require treaty changes in the then EU-27. This challenging issue and the related referenda, in particular, have tempted some to rather consider further integration through agreements between member states such as the creation of a European Monetary Fund. This idea was already brought up during the euro crisis¹³ but the establishment of the ESM now provides a nucleus for further development. While a bold fiscal backstop for countries and banks does make economic sense¹⁴, such an intergovernmental option with the ESM as a body of international law would raise further concerns over transparency and democratic legitimacy in the governance of the euro area (e.g. the role of the European Parliament).

EC roadmap for completion of Economic and Monetary Union by 2025 (key measures) 13

Period 2017 - 2019

Setting up a fiscal backstop for the Single Resolution Fund, agreement on European Deposit Insurance Scheme (EDIS)
Finalisation of Capital Markets Union initiatives
Stronger focus on support of reforms and convergence standards
Integrating Fiscal Compact into EU legal framework

Period 2020 - 2025

Issuance of a European safe asset and changes to the regulatory treatment of sovereign exposures
Agreement on central stabilization function (investment protection fund, unemployment insurance), euro area budget
Eurogroup with a permanent chair and as official Council configuration
Euro area Treasury and/or a European Monetary Fund

Sources: European Commission (2017): Reflection Paper on the deepening of the Economic and Monetary Union, Deutsche Bank Research

Parties' positions on the future of Europe differ in scope and level of detail

The topic on how to shape the future of the EU and the euro area in particular, is not dominant in the election campaign. This is quite surprising given the controversial debates in Germany during the height of the sovereign bond crisis or about the various rescue packages for Greece. The SPD candidate Martin Schulz is aiming at leveraging his background as former President of the European Parliament but as in previous elections, the German electorate seems to be more interested in domestic topics such as social policy, taxation or security (chart 17). EA issues obviously only catch the attention of the broader public and related debate heating up when a decision on the European level is about to be taken.

CDU/CSU manifesto rather vague on European topics

The CDU/CSU programme repeats a line Chancellor Merkel has stated in an earlier speech and which has been widely interpreted as a commitment to deepen European integration: "The times in which we could fully rely on others are, to a certain extent, in the past. We Europeans must take our fate into our

¹² Wolff, Guntram (2017): What could a euro-area finance minister mean?

¹³ Gros, D. and Mayer, T. (2010): How to deal with sovereign default in Europe: Towards a (Euro)pean Monetary Fund

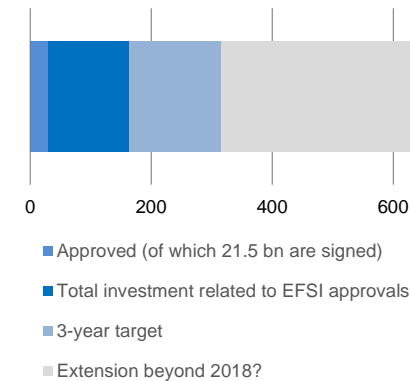
¹⁴ Sapir, A. and Schoenmaker, D. (2017): We need a European Monetary Fund, but how should it work?



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EFSI investment 14

in EUR bn, Dec. 2016



Sources: EIB Group, Deutsche Bank Research

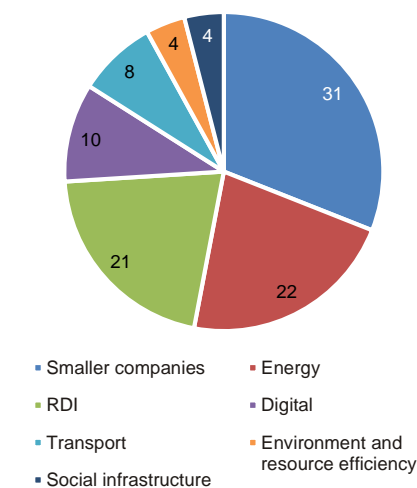
own hands more decisively than we have in the past".¹⁵ Referring to France and Germany as motor of Europe it reads that "we are ready, together with the new French government, to further develop the euro zone step by step, for example through the creation of its own monetary fund". However, it rules out support for any mutualisation of debt and links "solidarity" to compliance with the Stability and Growth Pact. Beyond that, there is no reference to changes in the EA governance or elements that have been included in the Commission's Reflection Paper on EMU.

There have been public comments by senior people of the CDU, however, that provide some more insights into the debate. At a conference of the Federation of German Industries Chancellor Merkel said that one could of course think of a common finance minister if conditions are right, referring also to the important principle of leaving risks, liability and decision power in one hand.¹⁶ Earlier FM Schäuble mentioned in a press interview that a euro finance minister would only make sense with an own budget and the competence to interfere in national budget planning should the fiscal rules not be adhered to.¹⁷ Chancellor Merkel also acknowledged that one might consider a euro area budget only as long as "it was clear that structures will be strengthened and sensible things will be done with it". This indicates more openness to discuss new elements but also signals that these topics are not fast-selling items with the conservative party.

SPD and Greens more outspoken on ambitious proposals

EFSI investment by sector 15

in %, based on approved operations, end-2016



Sources: EIB, Deutsche Bank Research

SPD and Greens are more detailed in their manifestos though they also refrain from discussing the concrete design of proposed new elements for the EA. The SPD in particular has presented a broad and far-reaching programme for deepening the EU. They call for an economic government of the EA under an EU economics and finance minister (Greens: EU Commissioner for economic and finance as the chair of the Eurogroup) with an EA budget that should be financed through taxing financial markets (Greens: European unemployment scheme). They support morphing the ESM into an EMF but explicitly demand to integrate it into Community law implying that decisions will be taken under the normal decision-making procedure involving the Commission, the Council and probably the EP. Minister of Foreign Affairs Sigmar Gabriel (SPD) endorsed the aforementioned Commission Reflection Paper on EMU and together with Martin Schulz supports the call of the French president for a European budget (Die Zeit, 10.05.2017, Der Spiegel 03.06.2017). Both parties want to strengthen democratic legitimacy/ control for the EP in EA matters including some sort of EA parliament or chamber within the EP. They perceive current EA fiscal policies as too restrictive (even calling them "austerity") and push for a European investment initiative possibly through increased funding of the Luxembourg-based European Fund for Strategic Investment, the EFSI¹⁸. Related is the SPD's call to reform the Stability and Growth Pact to allow (even) more leeway necessary for growth and undertaking of reforms. Both parties stress the importance of the social pillar of the EU referring to minimum wages and minimum social standards. The Greens and also Chancellor candidate, Martin Schulz, endorse demands that Germany has to accept higher fiscal

¹⁵ <https://www.cdu.de/regierungsprogramm>

¹⁶ <https://www.bundesregierung.de/Content/DE/Rede/2017/06/2017-06-20-rede-merkel-tdi.html>

¹⁷ <http://www.bundesfinanzministerium.de/Content/DE/Interviews/2017/2017-05-15-spiegel.html>

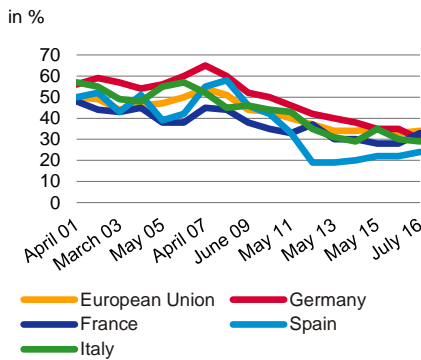
¹⁸ The EU Council has already agreed to extend the EFSI in terms of both duration and fiscal capacity, mobilising at least EUR 500bn of investments by 2020 (currently EUR 315bn by 2018). The respective EU Commission proposal which foresees a doubling of the investment target is now under discussion in the EP.



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Trust in the ECB

16



Sources: Eurobarometer, Deutsche Bank Research

responsibility post-Brexit and show more solidarity with debt-burdened partners.¹⁹

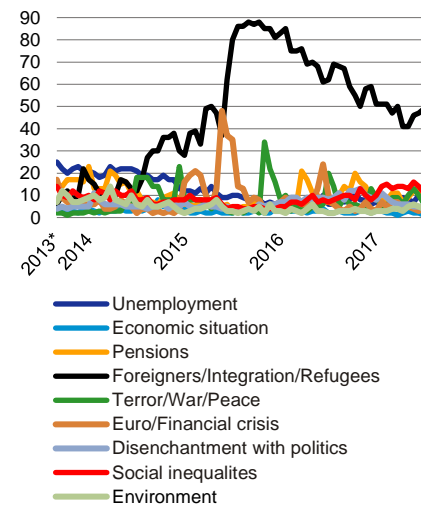
Liberals focus on compliance with fiscal framework

The FDP appears less inclined to buy into the various proposals that have been mentioned in the Commission's Reflection Paper or are put forward by the French president. They focus on the role of fiscal solidity as a core requirement of a sustainable EA and the member states' responsibility for ensuring that. They call for strict compliance with the fiscal rules incl. a reference to the application of automatic sanctions. An insolvency regime (debt restructuring procedures) for the EA should be set up and euro members should be able to exit the EA without leaving the EU which is currently not foreseen in the EU Treaties. They refuse anything that leads to a "transfer union" including a European unemployment scheme. The FDP is the only party that has a reference to the Banking Union in its programme being critical towards a common deposit insurance scheme and demand a phasing out of the zero risk weight for sovereign bonds to cut the nexus between banks and sovereign risk.

Most important problems in Germany

17

Max. 2 answers, percentage of those asked, %



* From the federal election (September 22) onwards

Sources: Forschungsgruppe Wahlen: ZDF Politbarometer (July 23, 2017), Deutsche Bank Research

Common positions of the parties

There are a number of topics, though, where the positions of the above-mentioned parties strongly overlap. The consensus view on Brexit is that while the negative economic and individual impact for both sides should be kept at a minimum, the unity of the EU-27 and that of the single market are the overriding aims in the negotiations. This implies that the next German government will remain constructive on the Brexit process but that there will be no particular move to accommodate specific British demands. There is also a cross-party understanding that asylum and migration issues require a speedy and common European answer. Looking at the polls this seems to be politically more important for improving the image of the EU and serving the broader public interest than the often technical discussion over Monetary Union. A two-pronged strategy should be envisaged with both the strengthening of Frontex and implementing common rules for acceptance and distribution of asylum seekers. Parties agree that member states which refuse to cooperate should assume a larger part of the financial costs or face other financial disadvantages. The Greens call for unified EU asylum standards and the substitution of the Dublin regime through a system supporting solidarity among the member states.

Alternative für Germany (AfD)

18

- EU should be reversed to an organisation similar to the European Economic Community (EEC)
- Referendum on Euro and EU membership
- Sovereign and democratic nation state must be sustained
- Build-up of German border control agency, but also free movement of persons and goods

Sources: AfD election platform, Deutsche Bank Research

Finally, to round up the German party landscape, the Left Party and the AfD cover European policy as well in their manifestos, some of them being in line with the mainstream parties, some of them being very controversial. For selected EMU positions of the AfD which has received broader attention beyond German borders in the course of the euro crisis and more recently the refugee topic (see chart 17). The Left Party calls, among others, for a EU-wide investment programme, to put the ECB under the control of the European Parliament and empower it to directly lend to sovereigns. The Left Party also wants to allow refugees to choose their country of destination while establishing some sort of fiscal compensation scheme (rightly assuming that the flows will concentrate on just a few EU member states).²⁰

¹⁹ In his "Zukunftspan" which complements the SPD manifesto Martin Schulz is both clearer and more far-reaching on certain proposals. It also explicitly states that non-euro area members should not be allowed to veto the evolution of the EA. <https://martinschulz.de>

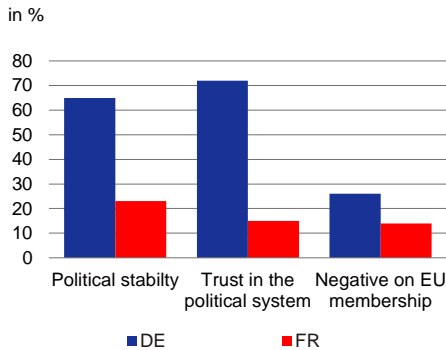
²⁰<https://www.die-linke.de/wahlen/wahlprogramm/>



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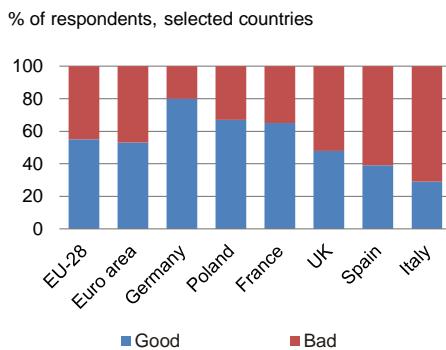
How special will the special Franco-German relationship be?

View on the own country and the EU 19



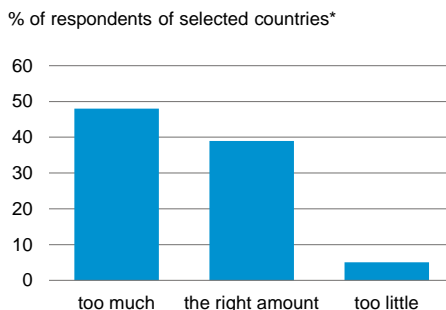
Sources: IFD Allensbach April 2017, Deutsche Bank Research

View on German Leadership in Europe 20



Sources: Bertelsmann Foundation 2015, Deutsche Bank Research

View on German influence in the EU 21



*: EL, ES, FR, HU, IT, NL, PL, SE

Sources: Pew Research Center 2017, Deutsche Bank Research

The bilateral relations are institutionalised to a degree not comparable with other groupings within the EU (e.g. biannual joint Cabinet meetings, exchange of ministerial officials).²¹ This, however, has not prevented political frictions from rising and positions diverging, resulting in lackluster Franco-German relations over the last couple of years. The election of Macron as French President has introduced a new spirit into the Franco-German axis and the two countries have announced that they have come up with joint proposals for European policy issues (one already explicitly mentioned was a joint effort to speed up talks on a common consolidated corporate tax base).

Also, an economic and politically-stronger France could bring some relief for Germany regarding its unintended role as “European hegemon” – neither wanted by German officials nor the broader public. Given its history, Germany was always seeking to become part of a larger entity and it was only since the financial and European sovereign debt crisis that the country was exposed to calls for more leadership.

Dealing with the differences which manifest themselves in the two “social-philosophical” angles Germany and France represent, namely the role of the state and the related approach to e.g. rules vs discretion or liability vs solidarity, is key for moving Europe forward.²² As the past has shown, a shared understanding of Germany and France how to move in certain policy areas is also essential to bridge different interests in the EU respectively the EA. However, this does not necessarily imply that Germany is ready to subscribe to the bundle of proposals for a euro area build-out that Macron is talking about. Merkel publicly supported Macron’s calls for deeper EA integration, albeit in general terms and pointing to necessary preconditions to embark on such a reform process. She admitted, though, that treaty changes should not be “a taboo” although there seems to be only low appetite among the EU partners given the experience with the EU Constitutional Treaty from 2004 and the Lisbon Treaty from 2008 (the first was rejected by referenda in France and the Netherlands, the second one challenged in the first round by a negative Irish referendum). In many regards the SPD and its frontrunner Martin Schulz show more (unconditional) support for the French position than Merkel and her CDU/CSU.

There is another area where views differ and will likely continue to do so. At least Merkel and her party want to avoid the potential that a deeper integration of the EA leads to a lasting split of the EU along the lines of euro and non-euro member states. This is the same question that arose in the context of Banking Union. New structures need to be designed in a way that they remain open to non-euro members and do not unnecessarily foster economic and political divergence along these lines. While the political position of the euro outsiders will weaken significantly with Brexit and the EA’s share in total EU GDP increasing to 86%, it would still be a carefully considered issue by a Merkel-lead government. In this regard the concept of a two-tier/ multispeed EU not only raises a number of questions but it is far from being a silver bullet to speed up changes in the EU-27.²³

Finally, using the same catchwords does not necessarily mean that one talks about the same thing. The idea of an evolution of the EMS into some sort of a European Monetary Fund is a good point in case. While the German position tends to prefer the ESM as an intergovernmental body and would even like to

²¹ See for example the latest statement of the German-French Ministerial Council Meeting, Paris July 13, 2017

²² Brunnermeier, M. et al (2016): The Euro and the Battles of Ideas

²³ GMF Policy Brief #005, 2017: Can core Europe move forward without a core?



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see the ESM taking over certain tasks from the Commission such as monitoring (more independently) compliance with fiscal rules others would rather see the Fund as a more generous lender for states and banks in troubles.

Thus, while an open and constructive debate on the evolution of the euro area should and will gain traction after the German elections (or rather the Italian ones in spring 2018), bridging German and French positions will remain challenging given the respective national mindset and domestic political constraints.

Composition of next ruling coalition matters – to a certain degree

Assuming Merkel wins the September elections as polls currently indicate, the attitude toward the contours of euro-area reforms will likely differ depending on the partner she will or can choose. Also, the composition of the cabinet posts, e.g. who would become the Finance Minister in the next government, is likely to play a role though not as much as foreign observers tend to believe. Nonetheless, all future developments (post-Brexit budget, EU defence plans, investment initiatives, macro stabilisation function etc.) will result in higher claims to the German budget and are likely to conflict with domestic spending wishes in tax reduction, social benefit increases and ultimately national fiscal rules. Also, as governance changes will start around the role and chair of the Eurogroup, the next Finance Minister will continue to be in the focus.

If the arithmetic only allows for a renewed grand coalition and the SPD is willing to become the junior partner for another four years, Merkel will likely have room for an ambitious deepening of the EA joining Macron on a number of proposals. Despite more supportive rhetoric, it remains unclear if she is willing to push forward decisively. It would be easier to get the backing of the coalition partner for implementing some of the ideas than from her own party, in particular the Bavarian arm of the CDU/CSU. But even a grand coalition would not put fiscal union on a fast track given the rather reluctant public sentiment to go down this road. Also, as with previous significant integration steps, the German Constitutional Court will have a role in the process as complaints are likely to be filed moving forward.

Should the CDU/CSU and the liberal FDP manage to get a (tight) majority which could be possible according to the current polls the coalition-internal debate would be much more challenging. While the FDP's manifesto does not spell out clear positions on individual EA reform proposals, the Liberals are likely to be more reluctant to support a broad transfer of sovereignty or engage in stronger funding unless the EA partners show their commitment to play to the current (fiscal and banking) rules.

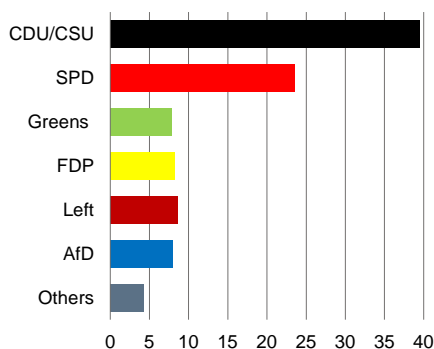
However, referencing the term 2009-2013, the then Merkel-led conservative-liberal government in the course of the euro crisis management took significant decisions in order to stabilise the EA (ranging from the bail-out packages for five euro area members to the establishment of the ESM and the first steps of Banking Union). Important too, there is a political understanding that far-reaching decisions in particular in European and foreign policy should be backed by a broad parliamentary majority even if formally not required. This was the case also for the years of the conservative-liberal government term where a cross-party consensus was sought after as well – and broadly achieved. Should the next coalition involve the Greens beside the CDU/CSU and the FDP, the so-called Jamaica coalition will need to find its own way to agree on speed and scope of changes in the build-out of the EA.

The benign political and economic environment should allow the current reform momentum to pick up, though audacious proposals promise heated debate within Germany and among the EU partners. To come to a common

Major political parties' popularity on the federal level*

22

Surveys published from mid- to end-July 2017, %



* Average of major surveys (Allensbach, Infratest Dimap, Forsa, Forschungsgruppe Wahlen, TNS Emnid)

Sources: Wahlrecht.de, Deutsche Bank Research



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understanding in Germany – not to mention an EU-wide consensus – will take time as there is no immediate pressure to move compared to the high times of the euro crisis. With Germany assuming the EU presidency in the second half of 2020 this might facilitate decisive decisions for Europe's future, though. Ultimately, the two key topics discussed here, the future path of European integration and how to deal with mass migration, will prove too complex and too controversial to allow for a clear-cut German strategy. Therefore we would expect rather gradual progress which Germany tries to manage in a cautious and contained way.

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