

Germany and Britain: an alliance of necessity

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Foreword

The Centre for European Reform and the Friedrich Ebert Stiftung are delighted to publish this pamphlet on how Germany and the UK can forge a closer alliance, one that would greatly benefit the European Union. With monetary union achieved and enlargement imminent, the Union needs to make huge changes to its institutions and policies. In this new period of flux, the Union badly needs – but currently lacks – bold leadership.

The opportunities for the UK and Germany to work together at European level are the best they have been in a political generation. Prime Minister Blair and Chancellor Schröder, two reformist leaders of the centre-left who get on well, have led Europe's response to the new global challenges that have arisen since September 11th. Each has a keen understanding of his country's interdependence with the rest of Europe and the wider world.

These two pro-European governments should take a common approach in many policy areas, and thus help to lead a reform agenda for the EU. We welcome this paper, for we believe it will spur politicians in Britain and Germany to strengthen and deepen their co-operation, in their interests and those of the whole of Europe.

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1 Introduction

The European Union needs a closer relationship between Germany and the UK. The Union has to make fundamental changes to its institutions and budget, and its economies require deep structural reform. But it lacks leadership. The Franco-German relationship, which drove major policy initiatives like monetary union, is weaker than it has been for many years. It is now as likely to hinder as to help the Union's development. A strong alliance between Germany and the UK – two large, reform-minded member-states – is vital to overcome the EU's inertia on tackling crucial issues.

In many areas that need urgent attention, Britain and Germany have common interests. They both want the EU to enlarge eastwards and to take on new foreign policy responsibilities. Both are keen on liberalising foreign trade and tackling agricultural reform. In other areas, however, they remain far apart. This paper considers where closer co-operation would be easy, and where difficult. We put forward ideas on how the two countries could reconcile some of their differences, and work together to further their own interests as well as those of the broader Union. This alliance is a working partnership, rather than one born of history and emotion like the Franco-German axis. But it is thoroughly necessary to push through long-delayed reforms of the EU.

Both governments face complex dilemmas over Europe. The UK's ambivalent position on the euro limits its influence in the EU. If the UK stays outside monetary union for many more years, its attractiveness to Germany and other European countries as a partner will diminish rapidly. If it joins, however, it could help to shape the eurozone to its own advantage and that of Europe as a whole. Germany's potential as a partner for Britain is also limited,

because it plays a supporting rather than a leading role in European defence. However, it has taken great strides forward since the terrorist attacks of September 11th 2001. The German and British political debates on European integration remain very different. But the two countries' political leaders have diagnosed many of the same ills in the EU – such as problems with legitimacy and transparency – and they are starting to propose some similar cures.

Then there is the question of France. The Franco-German relationship is under strain – although its demise has been greatly exaggerated. France is suffering from a profound sense of angst over its role in Europe, and its crisis of confidence is intensifying as EU enlargement approaches. Closer co-operation between Germany and the UK would not replace the Franco-German axis. France remains Germany's most reliable partner in pursuing the cause of European integration, whereas the UK is still ambivalent about many areas of EU policy. The Franco-German alliance was not invented to anchor the European Union; rather, the Union was created around that fundamental relationship.

But Europe is facing new challenges that are changing the balance of interests between France and Germany. The German government is more prepared to argue for national interests within the EU, and less willing to sacrifice long-term reform goals for the sake of its relationship with France. It is also more willing to enter into ad hoc alliances with other member-states on specific policy areas.

The opportunities for the UK and Germany to co-operate at European level are perhaps the best in decades. Germany is less preoccupied with the challenge of unification, and is in the process of 'normalising' its foreign policy and military roles. The UK is becoming a less reluctant player in European integration, and is even leading the EU in defence. The elections of 1997 in the UK and 1998 in Germany brought in dynamic younger leaders, replacing parties that had been in power for nearly two decades. Gerhard Schröder and Tony Blair represent a new breed of centre-left

politician, shaped by the events of the 1960s rather than the 1940s. Their views of Europe and their country's role in it are very different from those of their predecessors.

We argue that both Germany and the UK would benefit from a closer alliance on a number of key areas of EU reform. Two recent events have made co-operation more important. The first was the attacks of September 11th 2001, which provoked both countries to look anew at historically sensitive issues. For Germany, that issue is defence, and for the UK it is European integration. As UK Prime Minister Blair told the SPD Party Congress at Nuremberg:

For you, Europe is relatively easy as an issue; the commitment of military forces hard. For us, the opposite. To commit our military, relatively uncontentious; to commit to Europe causes deep passions.¹

In November 2001, Chancellor Schröder committed German troops in support of the US military campaign in Afghanistan, overcoming the doubts of many of his supporters and allies. Blair has argued persuasively that interdependence in security is a reality, and that it requires Europe to integrate more closely.

¹ Tony Blair, speech to the SPD Party Congress in Nuremberg, November 20th 2001.

The second change was the launch of euro notes and coins on January 1st 2002. This move has made many in Britain realise that the country's future role in the EU depends on whether it joins the eurozone. The UK's status – as a future member or a definite outsider – defines its approach to a range of institutional and policy issues. Conversely, Britain's position outside the euro shapes the reactions of Germany and other member-states to UK initiatives.

This paper is not about British-German bilateral relations, which are largely good, or the personal relationship between Germany's chancellor and Britain's prime minister, which is excellent. Rather, it is about the degree of convergence between the two countries'

national and European agendas, and about the choices faced by the two governments. We identify five areas where they should intensify their co-operation:

- ★ **Enlargement.** Although they have different levels of interest in central and eastern Europe, both countries are strong advocates of EU enlargement. Both see the successful integration of the applicant countries as more important than preserving the current Union. Britain and Germany will have to work together to ensure that the first accessions take place on time in 2004.
- ★ **Budgetary reform.** Germany wants to reform EU agricultural policy in a less market-oriented style than Britain. However, both countries want to see radical changes to EU farm policy. They must collaborate to overcome French opposition to reform.
- ★ **Defence and security.** German and British ambitions for a European security and defence policy are converging, as Germany takes a more active military role – although financing remains a key issue for Berlin. The two countries are keener than France to ensure that EU defence policy interlocks smoothly with NATO.
- ★ **Justice and home affairs.** The UK remains outside the Schengen area of passport-free movement, but both Germany and Britain want to push forward European integration in internal security. They should work together to forge a common asylum and migration policy for the EU.
- ★ **Economic policy.** The UK and Germany both want to liberalise trade and improve Europe's competitiveness. If Britain joined the euro, they could co-operate within the eurozone to promote structural reform and improve economic policy co-ordination.

SYNERGY AND CONFLICT ON EUROPE

Broad synergies...

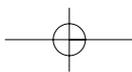
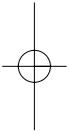
Enlargement	Both want enlargement to happen, and see it as more important than preserving the current budget and institutions.
The EU budget	Broad agreement on the need for major reform, in opposition to France and the net recipients. Both want reform of the CAP, but they differ over what kind of agricultural policy should emerge.
Defence	A complementary relationship: the UK leads, Germany follows. But there is friction on financing, which will make defence integration difficult.

... and serious conflicts

Monetary union	Uncertainty about UK entry and major differences on methods of monetary policy-making.
Economic reform	No further German effort likely before the September 2002 elections, and progress afterwards depends on the composition of the ruling coalition.
Tax harmonisation	The UK is implacably opposed.

Scope for convergence

Institutional reform	Conflicting grand visions, but many similar ideas on reforming the European Council, the Council of Ministers, and making EU foreign policy-making more effective.
Justice and home affairs	Both countries are pushing forward the EU agenda on internal security. But the UK is still partly outside Schengen, while Germany is blocking progress on a common asylum and migration policy.



2 An alliance for enlargement

Germany and the UK are both key supporters of enlargement among the 15 member-states, but the interests and attitudes behind their stances are very different. Germany has major economic interests in enlargement and the feelings of the German public on this issue are strong, in terms of both expectations and fears. By contrast, the UK is geographically more distant, has far less investment and trade with the applicant countries, and its public and interest groups pay little attention to central and eastern Europe. But the two countries could co-operate closely to push forward the process of negotiations and the first accessions.

For European politicians, the issue of enlargement is a great opportunity to display statesmanship and political vision. In the UK, it is relatively costless to advocate it. Unlike in Germany, France or Austria, there are very few interest groups voicing concerns about its implications. Hardly anybody in the UK opposes enlargement openly, and all the political parties are strongly in favour – a highly unusual show of unity on a European issue. Europhobes and europhiles both think enlargement is a good thing. Politicians from across the spectrum of opinion on Europe make speeches on expansion of the Union as an ‘historic opportunity’ – a ‘moral imperative’ even – without the qualifications about conditions and safeguards that would quickly follow if a German politician were speaking. Not only are British leaders largely unconcerned about wage competition from the applicant states, but unlike founder members of the Union, they do not fear the impact of enlargement on the coherence of the EU. And one of the major reasons British politicians support expansion is their belief that it will finally render the common agricultural policy (CAP) unsustainable.

It is unfair to suppose – as many other Europeans do – that the UK wants enlargement simply in order to dilute the EU and prevent further integration. Among much of the British political elite there is a real commitment to expansion eastwards on geo-political grounds, based on an understanding of the strategic importance and historical justice of embracing central Europe. Because of the UK's role as one of the 'great powers' that divided Europe at Yalta, the British debate about enlargement has a strong historical feel, and one that is largely positive.

Yet there are few British votes in enlargement. UK politicians have made great speeches on it – but mainly abroad. It is not a subject of much interest to the British public, because the candidates are still 'faraway countries of which we know little' to most people. British politicians can easily advocate enlargement, but not the sacrifices that may be necessary in order to achieve it. It is hard for them to argue on grounds of national interest because those interests are relatively small. As a result, the British government's enthusiasm for the integration of the candidate countries is not shared by public opinion. A few more tabloid headlines about east Europeans claiming welfare benefits in the UK, or foreign investors moving plants from the Midlands to central Europe, could raise public opposition quite fast. It only took a few thousand Roma to seek asylum at UK ports for the Home Office to impose visa restrictions on Slovakia.

The politics of enlargement in Germany are quite different. Central Europe is much nearer and the challenges are much more immediate than to Britons. The benefits of integrating these countries into the single market are evident in the profits of German firms that export to the region. However, more cross-border crime (such as car theft), illegal construction workers and immigrant beggars from the East are highly visible consequences of the fall of the Iron Curtain and the wars in the Balkans. Voters do not necessarily distinguish between people from non-applicant countries in the Balkans and those from the candidate countries. In Germany,

fears of wage competition and immigration are closely associated with the applicant countries, whereas in the UK such fears tend to be more readily associated with Asian countries owing to the legacies of colonialism.

The costs and benefits of enlargement are more intensely debated in Germany, partly thanks to the efforts of German research institutions, which have published major studies on the economic, political and social implications. As a result, the debate is better informed in political circles, and enlargement is discussed in much more detail than in the UK. There is a much wider circle of actors involved too: many parliamentarians are knowledgeable about it, and interest groups such as the trade unions and employers' organisations have produced in-depth position papers on enlargement. British firms take less of an interest, so the Confederation of British Industry has produced much less information on enlargement than its German counterpart, while British trade associations and unions have not formulated detailed positions.

Germany's federal structure also facilitates a debate about the implications for different regions and sectors that is lacking in the UK. For example, the Bavarian state government has put a vast array of material about enlargement on its website, more than the other Länder. This is not necessarily positive for enlargement, however, as Bavaria has been one of the most active Länder in demanding safeguards and transitional periods to cushion the potential impact of enlargement on its labour markets. The powerful Sudeten German lobby has demanded the restitution of property, taken at the end of the Second World War, as part of the accession deal for the Czech Republic. This degree of attention is unmatched by any region in the UK, even those which stand to lose regional aid as a result of poorer countries joining.

There are not many more votes in enlargement for Schröder than for Blair. Both leaders prefer to confine their speeches on the subject to the

geo-political and security arguments, rather the difficult implications for the EU's institutions and policies. For the Schröder government, the most awkward issues are reform of the CAP and the free movement of workers – although the latter has become less sensitive since July 2001, owing to the long transitional period that the EU then imposed on the applicants. Blair faces fewer immediate sensitivities, but his government has so far been cautious in pushing for the major institutional reforms that would ensure the Union functions effectively after enlargement. Moreover, the Treasury is adamantly opposed to giving up Britain's budget rebate, which will result in enlargement costing the UK much less than it otherwise would.

Economic interests

Germany and the UK may be the two main drivers of enlargement in the EU, but they are at opposite ends of the spectrum of member-states in their levels of economic integration with the candidates. Germany has a much higher degree of trade and investment in central Europe even than one would expect on grounds of geographical proximity, size of markets and historical ties.² The UK is the opposite: it has a tiny proportion of investment and trade with central Europe, both in comparison with its world role and relative to the other large member-states.³

² Alan Bevan and Saul Estrin, *The determinants of foreign direct investment in transition economies*, Centre for New and Emerging Markets Discussion Paper 9, London Business School, 2000.

There are several reasons why German firms have a higher level of involvement in candidate country markets. In addition to their home economy's size and export orientation, German investors benefit from similar legal systems to the German model in the candidate countries, which made it easier for German firms to do business, particularly in the early years of transition, when there was greater uncertainty in the region.

³ Barbara Lippert, Kirsty Hughes, Heather Grabbe and Peter Becker, *British and German interests in EU enlargement*, Continuum/RILA, 2001.

Structural differences between the UK and German economies also help explain the gap. First, there is the size of investing firms.

Germany's small and medium-sized enterprises (the SMEs, or *Mittelstand*) have been dynamic in creating cross-border investment and trade. British foreign direct investment tends to come from large firms, with SMEs accounting for a smaller part of British industry.

Secondly, the role of manufacturing and services in the two economies is very different. The UK economy has a smaller manufacturing base and a proportionately larger service sector than Germany, and so it has fewer incentives to locate business in lower-cost economies. Service industries are more dependent than manufacturing on stable regulatory frameworks and secure legal environments, so British services firms were reluctant to move into central European markets until the political, legal and business environment stabilised. The relative underdevelopment of services markets in the candidate countries offers fewer opportunities for UK firms, whereas manufacturing plants have been easier to establish.

Thirdly, German firms face a much greater cost differential with the candidate countries, owing to high wage levels at home. In the mid-1990s, when investment was growing strongly, manufacturing labour costs in the Czech Republic were one-eighteenth of those in Germany, but only one-eighth of those in the UK. British firms' lower labour costs have given them less of an incentive to move production to central European locations. Moreover, historical ties to low-cost Asian economies still encourage British firms to consider relocating production in that region, rather than in the candidate countries.

Finally, there are differences in financing patterns. The relationship between UK firms, their investor base and banks causes greater risk adversity in investment patterns and a shorter time-horizon for expected returns. Both these factors long deterred British firms from investing in little-known central European locations. The limited presence of UK financial institutions – especially banks – in the region may matter too, because it leaves UK firms with little help from British sources of finance.

The politics of enlargement

In the UK, economic considerations do not have much resonance in the enlargement debate. Partly because of the UK's limited trade and investment ties, candidate economies are not often portrayed as a competitive threat to UK firms. But the flip-side is that British politicians are just as unlikely to see enlargement as offering major economic opportunities.

By contrast, discussion in Germany of the costs and benefits takes place within the overall context of the long-standing debate on German competitiveness. An important feature of that debate has been fears of a 'hollowing out' of German industry, as firms relocate production away from high-cost German sites to cheaper central European locations. But economic interests have to be put into the perspective of the overall politics of enlargement. Just as important – and in some regions much more so – are factors like migration and crime.

A complex set of political and security considerations explains both German and British motivations for promoting enlargement. But Germany is more ambivalent about the countries on its doorstep. Berlin is also more concerned than London about the reaction of France, particularly with regard to the institutional and budgetary reforms that will be needed to make the wider Union work effectively.

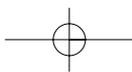
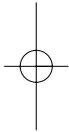
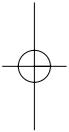
German policy-makers see the UK as a key ally in ensuring the accession of the new members. The UK provides unalloyed support for a fast and large enlargement from a neutral stand-point. It does not have Germany's strong economic and political interests in enlargement, so it can argue for the benefits of enlargement for the EU as a whole, with few vested interests.

Nevertheless, German-British co-operation will be critical in pushing policy reform to ensure that enlargement happens on time. The negotiations and ratification procedures could easily be blocked by

An alliance for enlargement

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France on the CAP, Italy and Spain on regional aid, Greece on Cyprus, or Austria on any number of issues. The UK and Germany should form the core of a coalition to drive the accession process forward and to overcome all the objections to enlargement. Such a coalition would be the most valuable contribution that a British-German alliance could make to the future of Europe.



3 Reforming the EU's institutions and policies

The most obvious areas for British-German co-operation on enlargement over the next two years are reforms of the EU's institutions, and its regional and agricultural policies. The UK is being more constructive in the debate about reform of EU decision-making than for many years. At the same time, Germany's ideas on how to make the institutions work better have evolved beyond its traditional solutions of increasing the powers of the European Parliament and of extending qualified majority voting.

Both countries want to prevent internal EU arguments about agriculture and regional aid causing a stalemate on enlargement. The EU will have to find an interim deal on these subjects in 2002, in order to close the negotiations in this area with the candidates. Other member-states, like Spain and France, are pushing for guarantees of continued financial transfers after the current budget period finishes in 2006. Both the UK and Germany would like to avoid such guarantees, and favour radical reform of the CAP. But they want different kinds of agricultural reform, with Germany pushing for an environmental agenda and the UK giving priority to liberalisation. Likewise, their ideas on reforming regional aid differ. But the two governments share a commitment to getting an interim agreement on the budget, thereby allowing enlargement to go ahead in 2004. That is a major incentive for co-operation.

The debate about the future of Europe

The tone and language of the public debates about the future of Europe are totally different in the UK and Germany. In his speech on the future of Europe at the Humboldt University in May 2000,

German foreign minister Joschka Fischer took a lead – for Europe as well as Germany – that other leaders have scrambled to follow. His vision is far more subtle than was suggested by the panicky headlines in the UK. But it is a vision of an enlarged EU organised on overtly federal lines. Fischer’s intention was to ensure the decentralisation of the EU, to achieve greater accountability and transparency. But in talking of ‘federalism’ – a dirty word in the British press – he allowed the eurosceptics to paint a lurid picture of a “German-dominated superstate”.

Blair responded to many of Fischer’s points in his Warsaw speech of October 2000. Their diagnoses of the problems facing the Union had a lot in common: both emphasised their concern about democratic legitimacy and their interest in new institutional solutions, such as a chamber of national parliaments to supplement the European Parliament. Both countries are more concerned about the EU’s democratic deficit than is the French political elite. However, German and British leaders have different visions of how to solve these problems. Blair has reaffirmed his preference for inter-governmentalism, with more power to a reformed Council of Ministers and a stronger role for prime-ministerial agendas. By contrast, Fischer sees the ‘Community method’, in which EU institutions play a leading role, as the core of the Union.

On the whole, Germany favours the decentralisation of European politics, through several layers of government, including the regions. British and French views are much closer than either country is to Germany, in seeing the representation of interest by national governments as the main source of legitimacy in the EU. Devolution of power to regional governments has started under the Blair government in the UK, but most Britons still do not share the German view that sub-national interests should be represented directly in EU policy-making. However, both governments want to involve national parliamentarians more closely in the workings of the EU.

The British and German domestic debates on the future of Europe centre on starkly different arguments. In the run-up to the 2004 inter-governmental conference, Germany is having a profound and constructive debate about the principles of European integration and how eastward enlargement will change the Union. But in the UK, the media remain highly sensitive to any mention of federalism or a constitution for the EU – so much so that they are often referred to as the ‘f-word’ and the ‘c-word’. That neuralgia has made it difficult to discuss openly ideas that some eurosceptics might welcome, such as a charter of competences to define clearly the responsibilities of the different levels of government in the Union.

However, Labour’s strategy on the future of Europe debate has begun to change in its second term of office. The UK is no longer drawing ‘red lines’ around areas where it wants to avoid change, and it is working on constructive and often quite radical proposals for institutional reform. Germany’s position is also shifting, as Schröder has started taking a greater interest in Europe and putting forward his own agenda.

Both the British prime minister’s office and the German chancellery are thinking creatively about how to reform the Union so that it remains effective after enlargement, and also becomes more democratic and legitimate in the eyes of the public. On some issues, advisors to the British and German leaders agree more with one another than with their respective foreign ministries, which hold to more traditionalist views. For example, foreign ministers do not appreciate the idea that a new council of prime ministers’ representatives could take over the work of co-ordinating the sectoral councils. Despite the differences in the two countries’ philosophies of Europe and their domestic debates, the Blair and Schröder governments could produce a joint agenda in several key areas.

First, Germany and the UK could work together to make the European Council function better. The European Council is not an

effective forum for complex decision-making and the solution of long-term problems. The agenda is too often overcrowded with items that the EU presidency has failed to resolve, or overwhelmed by a sudden crisis. It is a monumental waste of prime ministerial and presidential time to spend days haggling over minor issues, so that each has some small victory to present to the electorate on returning home. Often, the result is low-quality decisions, because the heads of government are prone to grandstanding and cannot necessarily follow all the details of the issues they are discussing. The shared frustration of British and German diplomats gives them an incentive to propose innovations to make the European Council work better.

Secondly, both countries want to reform the Council of Ministers. It is not working well with 15 member-states, and enlargement will exacerbate the problems of inefficiency and fragmentation of policy-making. Most British politicians and officials disagree with the purported German preference for making qualified majority voting the general rule in decision-making, because the areas that remain subject to a unanimous vote are very sensitive. Nor are the British so keen as the Germans on strictly separating the legislative and executive functions of the council.

However, both could support reducing the number of councils – down to ten or fewer – and cutting out the *tours de table* of speeches from each country representative. Both German and British leaders believe that opening up council meetings to the public and press – at least when it is legislating – would enhance the Union's transparency and accountability.

A third area for potential co-operation is in improving the effectiveness of EU foreign policy-making. For all Germany's problems with defence policy, it is a strong supporter of a more credible EU foreign policy. Both countries are prepared to consider a merger between the jobs of the high representative for foreign policy and the commissioner for external relations. Both could support the abolition of the EU's rotating presidency, at least for foreign policy. Germany

has traditionally been reluctant to change the rotation system, because it did not want to upset the small countries that enjoy their turn with the presidency. But now that the views of several small countries – including the Netherlands and Belgium – have changed, the issue is open to discussion.

Finally, the UK is becoming more open to two ideas that Germany has long supported. One is the integration of the Charter of Fundamental Rights into the EU's treaties. The British Foreign Office is still opposed, but others in the British government support the idea of making the Charter legally binding. All the other member-states are in favour of its incorporation into the treaties in some way, so the UK is isolated in its opposition.

The second idea is the creation of a constitution for the European Union. The 'c-word' still causes consternation in the UK, but Tony Blair was fairly relaxed about discussing constitutional arrangements at the Laeken European Council in December 2001. Germany, for its part, might agree to call such a document a 'basic law' or 'constitutional treaty'. The Laeken declaration, which set out an agenda for the debate about the future of Europe, called explicitly for the Convention – which will prepare the next inter-governmental conference – to work towards a constitution.

Budgetary reform

German and British approaches to reforming the budget and the policies it supports are converging, particularly on the CAP. Both countries are net contributors to the EU budget, with Germany paying in by far the largest sum of any member-state. Many Germans are in favour of reducing their country's payments into the EU's budget substantially. Because of this *Nettozahlerdebatte*,⁴ the German government's priority is to reduce the overall size of the German contribution, and to keep the budget well under its current ceiling of 1.27 per cent of EU GDP. The UK is also keen to avoid any growth in the overall EU

⁴ *The debate on Germany's net contribution to the budget.*

budget after enlargement, and the British government is hanging on tenaciously to its budget abatement, a complex formula which reduces its net contribution. Germany is open to the idea of a new system for financing the budget, but the British public is still hypersensitive to the idea of any kind of 'Euro-tax'.

However, Germany now has more in common with the UK on the budget than it has with France. This is a significant change since the EU's last attempt to overhaul the budget, at the Berlin European Council in 1999. Then, the EU failed to introduce radical reforms to the CAP because neither Schröder nor Blair was prepared to fight Chirac on the issue, so the carefully prepared deal unravelled.

The German position has changed since 1999, to favour more radical budgetary reform. The German elections in 2002 will not be won or lost on agriculture, and most farmers do not vote SPD in any case, so the Schröder government has less reason to pander to them than its predecessor did. The Berlin government is also less beholden to the eastern Länder on regional aid, as unification becomes more distant. Germany's position on the structural funds (the main source of regional aid) is becoming more like that of the UK: there are local sensitivities in the regions that are recipients of substantial aid, but these are less important than the goal of enlarging the EU eastwards on a financially sustainable basis.

Agricultural policy is the most difficult area of the budget. The CAP takes up nearly half of the EU's budget, and it is difficult to wean farmers off the subsidies they have received over decades. German policy has changed as a result of the crisis over BSE ('mad cow disease'), and the appointment of Renate Künast, a prominent Green politician, as federal minister for consumer protection, food and agriculture, in January 2001. Her aim is that a fifth of all food production in Germany should be organic within a decade. For the CAP, she is proposing that subsidies be redirected from large-scale farms that use intensive farming methods to smaller ones that produce organic food, and that food safety should be given more priority.

The German social democrats are also contemplating radical reform of farm policy. In its draft policy document for the 2001 party congress, the SPD proposed significant changes, including the 'co-financing' of agricultural subsidies so that national budgets pay a proportion of the costs.⁵ For the EU as a whole, the ⁵ SPD document suggested that policies currently decided at EU level should be transferred back to national governments, if the single market does not require EU involvement. In particular, the member-states should take over large parts of the EU's agricultural and structural funds. Chancellor Schröder backed away from these positions when the document became public. However, the SPD proposals signalled where German government thinking was heading, and the willingness of many Germans to consider radically new approaches to the EU budget.

The SPD's thinking is very different from the views of the Parti Socialiste – its French counterpart – whose own 2001 policy document on the EU defended both the CAP and regional aid funds, and suggested that the overall EU budget should be increased to cope with enlargement.⁶ Although some prominent French socialists support a re-nationalisation of the CAP,⁷ the government is opposed because of the potential cost to the French taxpayer of supporting France's farmers.

Germany's new approach was strongly welcomed in the UK. However, the two countries diverge on the nature and size of subsidies to farmers. Both want to move away from the CAP as currently constructed, and will probably push for fundamental change after the EU conducts its mid-term review of the policy in June 2002. However, there are concerns on the British side that Künast wants to maintain market-distorting subsidies in order to encourage the development of organic farming. For her part, Künast is suspicious that the UK just wants to spend as little as possible on agriculture, rather than supporting a fundamental change in farming methods.

The big question for UK-German co-operation on the CAP is whether the Berlin government will hold out against French opposition to reform. If the next French government – formed after the June 2002 elections – is vehemently against change, Berlin will need very strong nerves to maintain a reformist position on the budget. If the Paris government blocks reform entirely, Germany could cave in just to avoid a row with France. Yet again, the long-term goal of reform could be sacrificed to keep the Franco-German duo together. This is the recurring nightmare for the British, and they have to work with Germany to prevent it happening again.

The UK needs Germany as an ally to fulfil its long-held goal of reforming the CAP. The credibility of the UK on agricultural policy is very low, following the crises over BSE and foot-and-mouth disease. The British agricultural model is not one that other countries want to follow. However, the UK could work with Germany to reduce the overall level of EU subsidies to farmers, and to build a more rational system of support for rural development that does not distort international trade. The two countries could support a range of proposals that would start a process of reducing EU-level support for farmers. After all, the direct payments that go to farmers are effectively a form of social security to supplement their incomes: no other sector receives such income support from the EU budget.

Similarly, a British-German plan for the CAP could propose faster liberalisation of agricultural trade with the rest of the world, both to open the EU's own markets and to make faster progress in the current world trade round. Neither of these proposals would necessarily prevent Germany from encouraging the development of organic farming – as Künast would like. Both countries could re-direct money now spent on the CAP towards rural development and environmental objectives.

Overall, both countries have strong incentives to push for a radical reform of the EU's budget. The UK should give up its rebate in

return for a fundamental reform that would offset the special payment that it would lose. Then the budget would no longer contain an anomaly that causes resentment among other member-states, and the UK would not have to contribute more overall. The UK's hard line on the rebate diminishes its credibility when advocating budgetary reform. Other member-states see Britain as hypocritical: it is enthusiastic for enlargement but will not discuss eliminating its special deal which reduces the cost of enlargement.

Both countries should advocate the re-nationalisation of the EU's agricultural policies, and forge an alliance with other pro-reform countries to overcome French opposition. They should finance regional development from their national budgets, so that after enlargement, EU regional aid can be focused on the poorest parts of the Union.

Political dynamics in the enlarged EU

Will enlargement of the Union polarise or unite Germany and Britain? The political dynamics of the Union will change after enlargement to 25-plus member-states. More members and greater diversity will put the current structure under strain, but the difference will be more than arithmetical. There will be a qualitative change in the Union's ambitions, political dynamics and responsibilities, one which will open up new opportunities for bilateral co-operation.

The enlarged EU's political system will have to become more flexible. The ability and willingness of member-states to be integrated into the EU's policies will vary much more than in the current Union. Progress in individual policy areas – like economic reform, taxation, borders policies and foreign policy – will often be driven by coalitions of the willing and able, rather than by the Franco-German relationship. This may not be a problem for European integration: a senior Swedish policy-maker observed during the Swedish presidency in 2001 that “in our first six years of

membership, the Franco-German axis has only ever been used to block things, not to push things forward.”

The question is whether informal coalitions can work without the involvement of France. The worry in Berlin is that if Germany teams up with other EU members regularly, the reaction of the French government could be suspicion and resentment. There is still an active, institutionalised Franco-German relationship, but it is increasingly strained, and the period of *cohabitation* since the 1997 French elections has been particularly awkward. French decision-making has often been paralysed because of a lack of agreement between the Socialist government and the Gaullist president.

But France has also been prickly because its role in the world is changing. The EU no longer serves French interests as it once did, and many in the country’s political and business elite see enlargement as a further threat to France’s role in the world. France fears that the new member-states will be largely Anglophone, Atlanticist, supporters of free trade and opponents of agricultural subsidies. In fact, the candidates have diverse views on these issues. However, they are unlikely to support many long-held French positions on the budget, external economic policy and cultural exceptionalism.

Many German policy-makers feel an obligation to ease France’s psychological adjustment, as it becomes a less important member-state in the enlarged EU. They will be careful not to encourage a sense of isolation in France, and to keep the Franco-German partnership active. But such a strategy should not rule out closer co-operation with the UK.

4 Ensuring European security

Europe is the most successful political project in our varied and sometimes bloody history. Europe is not only the peoples' answer to war. I am convinced that Europe will also play a vital role in the peoples' answer to terrorism.

Gerhard Schröder to the 2001 Labour Party Conference.

Britain can't play its part in developing a more stable and peaceful world but shy away from Europe, its most powerful alliance right on its doorstep. Germany can't play its part in helping lead this new world, without accepting its full international responsibilities.

Tony Blair to the 2001 SPD Party Congress.

Security policy is the next major area of European integration. The EU has two burgeoning areas of security policy at present – a common foreign and security policy, and internal security through co-operation on 'justice and home affairs' (JHA). Domestic attitudes on these subjects have changed gradually over the past few years in both countries. But the terrorist attacks of September 11th have hastened a long-overdue re-think. Germany has finally started to move towards playing a role in European foreign policy that is commensurate with its size. At the same time, the UK is in the vanguard in developing internal security policies for the Union.

Defence and external security

Germany took two major strides forward in foreign and security policy in the autumn of 2001. The first was long-planned: Germany

sent combat troops to participate in the NATO force collecting weapons in Macedonia, and then took over the leadership of the protection force for Organisation for Security and Co-operation in Europe monitors in the same country.

The second shift followed the terrorist attacks in New York and Washington. Chancellor Schröder pledged “unlimited solidarity” with the US, and left not the slightest doubt about his backing for the Bush administration’s initial counter-attack. But it was not easy for the chancellor to offer such whole-hearted support to the Americans. He came under fire from the right for his initially slow response and for Germany’s minor role in the military action. To many on the right, it is embarrassing that “Blair plays in the first division, Schröder in the second,” as the conservative newspaper

⁸ *Welt am Sonntag* wrote shortly after the attacks.⁸

⁸ *Welt am Sonntag*,
October 7th
2001.

On the left, however, Schröder’s room for manoeuvre was severely constrained by opposition to the US bombing of Afghanistan in the SPD and its coalition partner, the Greens. Public opinion was divided between a desire to support the US and a distrust of American foreign policy. Germany’s top leadership has tended to be firmly Atlanticist. But further down the political system, support for such policies is less firm.

The prospect of even the most limited German involvement in military action shook political allegiances. Joschka Fischer, the foreign minister and most prominent Green politician, pledged his support for German engagement; yet no political party was more divided over active involvement in the battle against terrorism than the Greens. The party – a coalition of environmental, anti-globalisation and pacifist movements – found itself confronted with two unappealing options: support the chancellor and risk disillusionment among its supporters, or bring down the coalition and face electoral annihilation.

Schröder took a risk in November 2001, and won approval for his plans to send nearly 4,000 troops in support of the US military

campaign. To succeed in a vote of confidence in the Bundestag, Schröder had to gain the support of the SPD party faithful and the Green party congress. The vast majority of party activists – Social Democrats as well as Greens – had been against military action, but Schröder's gamble paid off. It was an important step towards the 'normalisation' of German foreign policy. Schröder himself declared that Germany's role as a 'secondary player' in international affairs was over. For the first time, the Bundeswehr was sanctioned to participate in a combat operation outside Europe. Although the number of soldiers was small and there was an arduous battle for parliamentary approval, this is a significant step for Germany.

Domestic politics makes Germany a difficult military ally. However much Washington may have appreciated Schröder's avowals of support, the US would be well advised not to stretch his loyalty too far. The chancellor has little room for political manoeuvre. Hence his public warning to US President Bush in December 2001 that Germany could not support a wider war in the Middle East. Schröder could support a 'war on terrorism', because that is a struggle about which the German public is generally positive, given the country's own battle against the Red Army Faction in the 1970s. But the public remains very wary of involvement in any other kind of war.

Prime Minister Tony Blair had few such worries. He led the UK into a high-profile role that was broadly supported across the political spectrum. Britain's vocal but very small anti-war movement failed to rally much support during the Afghan campaign. In Germany, a much larger proportion of the population supports pacifism. Perceptions of threat are also different: the German public is still more concerned about stabilising the EU's 'near abroad', while the UK continues to take a more global view.

For Blair, the war on terrorism has offered an opportunity to encourage the UK to re-think its attitudes towards Europe. He used the crisis to point out to the British the link between their own

welfare and that of the rest of Europe, between security at home and abroad. His speech at the Labour Party Conference on October 2nd 2001 showed the breadth of his vision for the UK, Europe and the wider world. His argument led from the war on terrorism to interdependence, from interdependence to the increasing need for European integration, and from the EU to British membership of the euro. He managed to rally public support for European security co-operation. But it is very uncertain whether the British public will follow Blair's logic all the way to the euro.

The events of September 11th 2001 matter greatly for European foreign and security policies, and particularly for Germany's future role in them. In a CER paper written before the attacks, three defence experts argued that Britain, France and Germany should provide leadership for an integrated European defence force.⁹ However, the reality in the embryonic European defence policy has been Germany playing the role of a junior partner to France and the UK. In NATO, Britain and Germany have been close partners. But Germany has long been reluctant to take on a military role beyond the defence of its territory, whereas the UK has frequently sent forces overseas.

⁹ Gilles
Andréani,
Christoph
Bertram and
Charles Grant,
*'Europe's
Military
Revolution';
CER, 2001.*

The attacks on the US have started to alter German attitudes to security policy and military intervention. They provided a catalyst for Germany's role in international affairs – which was already shifting – to change more quickly. The Schröder government now has more freedom than its predecessors to co-operate actively with the UK in order to build European defence capabilities.

While Germany and Britain have been close partners within the existing system, they do not see eye-to-eye on some of the changes currently underway. Proposals for a European rapid reaction force have provoked a fundamentally different political controversy in each country. In the UK, there is widespread opposition to the idea of a 'European Army' – a concept with which most Germans have

few difficulties. The Germans, in turn, still have major political problems with the financial implications of defence integration, and would struggle to deploy a major force overseas.

The Bundeswehr, a conscription-based army, was designed for territorial defence rather than modern military challenges. It can thus only provide limited support for campaigns outside the NATO area. In the Afghan campaign, for example, Germany provided logistical support, help with the processing of intelligence, and protection of US bases in Germany. The Bundeswehr needs a complete overhaul to transform itself into a professional army. It badly needs new military equipment, and it needs money. Germany spends far less on defence than its main allies: about 1.5 per cent of its national income, the lowest of the big NATO powers and below the EU average of 2 per cent. However, the government's problems in getting Bundestag approval for the A400M military transport aircraft in January 2002 illustrate German reluctance to spend more.

Defence spending and military capabilities are the critical differences between the UK and Germany, but there are also constitutional constraints on Germany that make co-operation difficult. According to the German constitutional court, the government must have the authorisation of the Bundestag for any military operation. Moreover, the German military can operate only within a multilateral alliance, whereas the British armed forces are under no such obligation.

Slowly but surely, Germany is moving towards becoming a more active member of the western alliance. However, it needs to work faster in re-configuring its armed forces. Most of all, it needs to commit more resources to security policy so that the Bundeswehr can contribute fully to allied operations. The UK and Germany share similar views on NATO, regarding the US role in European defence as crucial, unlike France. They have a long-standing tradition of joint development of military equipment, including the

Tornado and the Eurofighter. And their present governments are open to further European integration in defence policy. If the EU is to create an effective military capability, Germany must upgrade its supporting role in European defence to a full partnership with the UK and France.

Internal security, justice and home affairs

If the terrorist attacks of September 11th accelerated changes in defence policy, they brought about an equally fundamental transformation of internal security policy. Within a few months, the EU was able to pass a range of anti-terrorism measures that would otherwise have taken years to grind through its decision-making apparatus. By the end of 2001, the EU had agreed on a common arrest warrant that will replace the system of bilateral extradition treaties between member-states, as well as a host of specific measures to enable police forces and judiciaries to work together more effectively to catch and prosecute suspected terrorists.

Both Germany and the UK have actively supported the EU's expanding JHA agenda. The two countries share a desire to see the Union develop an 'area of freedom, security and justice' – as decided at the Tampere European Council in 1999 – and both have feisty interior ministers who are unafraid to take a tough stance in their national debates. However, the two countries have very different priorities and national sensitivities.

UK Home Secretary David Blunkett has been pushing EU integration forward in areas like the common arrest warrant, where Germany long blocked progress. At the same time, German Interior Minister Otto Schily is pressing the EU to adopt more border control measures, and even proposing a common European border guard. This is a difficult area for the UK because the country remains outside the EU's Schengen zone of passport-free travel, and does not take part in EU initiatives that affect border controls. Likewise, German proposals for the EU to introduce new methods of proving

identity – such as the use of fingerprints in visa stickers and residence permits – are not popular in the UK, which has no identity cards.

The British and German interior ministries have been two of the most active in putting forward anti-terrorism measures at national level. Schily managed to push two packages of legislation through the Bundestag, despite the opposition of the Greens and many SPD parliamentarians. Blunkett also managed to gain parliamentary approval for some very controversial measures, such as the detention of terrorist suspects without trial. He even raised the possibility of introducing compulsory identity cards, long a sensitive issue both for the civil rights movement on the left and libertarians on the right.

In both countries, the new anti-terrorism measures have engendered a lively debate about their implications for individual citizens. Both Blunkett and Schily are under attack from the left on civil liberties, but their proposals have helped their leaders to fend off attacks from the right on law and order. This debate is more intense in Germany, owing to the constitutional principles of the federal republic, which include strong data-protection rules.

Given this raft of legislation, it has been difficult for the CDU/CSU to make political gains on its traditional ground of law and order. Its candidate for the chancellorship in 2002, Edmund Stoiber, has attacked the government for failing to protect citizens from internal security threats and for not spending enough on defence. But fast action on internal security has helped the governing coalition to outflank the right. Chancellor Schröder says ¹⁰ *Interview in Le Monde, October 30th 2001.* that when the Greens and the left of his own party complain about Schily's policies, he reminds them that the voters like populist judge Ronald Schill, who won office in Hamburg in September: "If you don't like Schily, you will have Schill. It's like that!"¹⁰

The terrorist attacks changed security priorities for most countries, and Germany changed both its external and internal security policies

in ways that would not have been possible before. Just as the country embarked on a new debate about defence and military intervention, so the government also overturned many long-standing tenets of post-war policy in home affairs. The state has gained new powers over individual citizens, and the ability to monitor their lives more closely.

The British debate about European-level internal security measures has become more positive since September 11th, but it was helped by a longer-running rethink on asylum policy. Indeed, in its first term in office, the Blair government discovered that the justice and home affairs agenda was a way to make the EU more popular in Britain. Its focus on co-operating at EU level to combat crime and illegal migration generated widespread public support.

That explains why Britain was in the vanguard of member-states pushing forward European integration in internal security after September 11th. At the Laeken European Council in December 2001, the EU agreed to introduce a common search and arrest warrant that will apply to serious, organised crimes, as well as to terrorist offences. The warrant will replace extradition procedures between member-states. The UK pressed for a negative list of crimes to which the arrest warrant would not apply, so that all other offences would be covered by it.

Germany was more cautious. It wanted a more restrictive positive list, so that the warrant would only apply to some serious crimes. Germany's key problem with the arrest warrant was that it abolished the principle of dual criminality: extradition will be automatic, even when the offence committed is not legally identical in the requesting country and the country where the suspect is caught. Germany had long blocked the removal of dual criminality, owing to constitutional problems.

The activism of Germany's chancellor and interior minister in pushing forward internal security measures is often not matched by

enthusiasm among the bureaucrats who have to implement them. The resulting lack of action on the Tampere agenda is causing frustration in the British Home Office.

The UK and Germany could co-operate a great deal more in developing parts of the internal security agenda. However, the scope for them to form a strategic partnership on justice and home affairs as a whole is limited for two reasons. The first is Germany's reluctance to compromise with its partners on several key issues in the proposed EU common migration and asylum policies. One is the definition of a refugee, and whether persecution by 'non-state agents' or sexual abuse should be grounds for granting asylum – some in the German government say it should not. Another issue is setting an age-limit for the children who can join parents granted asylum in the EU. Germany would like a lower limit than other countries, and some CDU politicians have argued for an age as low as two or three years. Schily's priority is guaranteeing internal security, rather than integrating migrants into society and dealing with demographic shifts.

The limitation on the British side is that the UK remains outside the EU's Schengen area of free travel without frontier controls. Britain never formally joined Schengen – along with Ireland, which stayed outside owing to its open border with Northern Ireland – because of its island geography. The UK is in the process of joining some parts of Schengen, such as police and judicial co-operation, but it remains outside the common border control provisions. The UK's approach is to rely on strong external border controls, so that once foreigners are in the UK, their movements are little monitored.

The Schengen opt-out presents both practical and political problems. Other member-states are unwilling to co-operate even on bilateral issues while the UK remains outside; for example, the French authorities complain that they cannot offer full co-operation in preventing illegal migrants from entering Britain from France because the UK is not part of Schengen. In future, the UK will find

closer co-operation with European partners essential to protect its borders, given the existence of the Channel tunnel and the increasing willingness of would-be migrants to cross the sea in small boats.

Politically, it is difficult for the UK to be involved in new initiatives on border controls because of the opt-out on external borders, even though technically Britain could probably opt into any measure it chose. Moreover, British influence in justice and home affairs co-operation is limited overall because it is not represented on the key committees that decide Schengen policies.

In future, 'coalitions of the willing' are likely to drive integration in justice and home affairs. Following September 11th, an ad hoc group – including Germany but not Britain – is discussing a range of options for closer co-operation to protect the EU's borders, with preliminary proposals expected in spring 2002. Germany will be at the heart of many such initiatives, helping to shape them from the outset. But the UK will be constrained by its Schengen opt-out, despite the Labour government's enthusiasm for international co-operation in protecting internal security.

Germany and the UK find it difficult to co-operate on JHA, owing to different national traditions and divergent public attitudes on issues like data protection and privacy. Yet both countries want the EU to move forward in this area, and they have shared concerns to prevent both terrorism and illegal migration. In order to foster an asylum and immigration policy for the Union, the UK will have to speed up its integration into the Schengen area, while Germany must be prepared to compromise with its more liberal EU partners on asylum policy.

5 The politics of monetary union

The introduction of euro notes and coins has shifted European economic integration into a new phase. Public support for the new currency regime has increased dramatically outside the UK. The focus of debate is now moving to the policies needed to manage the eurozone, with its 12 members setting the agenda. According to one senior German official: “The UK can contribute very little to the debate. Economic policy is made by the Euro group, and Britain is outside.”

The British debate, in contrast, remains stuck on arguments about the pros and cons of the Economic and Monetary Union (EMU). But while the level of British public opposition to the euro now is not so much higher than it was in Germany in the 1990s, the politics are markedly different. Germans were cautious about the new currency because they were attached to the D-Mark, and they were worried by the fall in the euro’s value against the dollar after its launch in 1999. But the single currency was never a priority issue for voters, and the German government and parliament were overwhelmingly in favour of monetary union. Indeed, all political parties except the post-communist PDS supported the Maastricht treaty, which established the plans for EMU.

In the UK, the euro does not rank high among the priorities of British voters either. The Conservative Party’s strategy of presenting the general election of 2001 as a de facto referendum on the euro backfired badly. Nevertheless, the British and the German political systems reacted very differently to the question of monetary union because of variances in political culture and the distribution of power. The British government has significantly less freedom of manoeuvre than its German counterpart on European policy. In

Germany, there was scepticism about monetary union, but the British government faces outright hostility.

The politics of European integration are quite different in Germany from the UK, for two major reasons. The first is the existence in Germany of a broad-based pro-European coalition that extends far beyond the governing coalition. It includes the Länder in the Bundesrat (the upper chamber), various interest groups, employers' associations, trade unions and the churches. In some combination or other, this coalition determines the outcome of most legislation.

The British constituency-based 'first-past-the-post' system ensures a very direct relationship between citizens and their legislators through elections. In Germany, that relationship is complemented by several kinds of political institution, including mass-membership parties and social partners. Democratic representation is built into the German political system at many different levels, which buffers the impact of fluctuations in public opinion. The system favours consensual decision-making and longer-term policies, particularly in European integration.

The second difference in the political cultures of the two countries lies in the role of the press. The opinions expressed in the editorial columns of UK newspapers and the broadcast news play an often critical role in British politics. The British government would probably find it impossible to win a referendum if the national press were to unite in opposition to joining the euro. Moreover, the Blair government is extremely sensitive to the views expressed by the eurosceptic press. By contrast, when Germany's *Bild* newspaper ran its famous headline – '*Das Ende der D-Mark*' – the day before EU leaders met in Maastricht in December 1991, nobody feared that popular outrage would stop the single currency. During the period from 1991 until 1998, influential columnists writing in the *Süddeutsche Zeitung*, *Frankfurter Allgemeine Zeitung* and the powerful news magazine *Der Spiegel* were united in their opposition to the choice of 1999 as the starting date of the final stage of

monetary union. However, the press failed to influence the German government, which is less sensitive to opinions expressed in the media than to the demands of a multi-layered political system.

Scenarios for Britain and the euro

The UK is an unpredictable ally for German policy-makers because of its intense domestic debate about Europe and its media-driven political culture. Even the change to a pro-European government after the 1997 general election did not eliminate this unpredictability entirely. As a senior German policy-maker explains:

At working level, we find the British easier to deal with than the French, because they are straightforward and forthright. But we can never rely on them to support us in any major initiative. We are forced back into the arms of the French whenever we want to take European integration to a new stage.

The UK's reputation for unreliability has been made worse by its dithering over whether to join the euro. The question of monetary union overshadows many aspects of the relationship between the two countries, and it also hangs over the whole British debate about European integration. The Germans feel they cannot rely on the British because a new twist in the domestic wrangle over the euro can cause a sudden weakening in the British commitment to other European initiatives. The UK is certainly not the only country whose domestic politics affect its European policies, and the Germans are equally frustrated by the unpredictability of the French during *cohabitation* governments like the current one. But the UK's uncertain position on the euro makes co-operation exceptionally difficult, because it affects British attitudes to a whole range of European issues.

There are three possible scenarios for the UK's relationship with the eurozone:

- ★ Britain decides to join in the next 18-24 months;

- ★ it remains undecided for the next four years; or
- ★ it decides definitely not to join until the next parliament, after 2006.

The first scenario is possible if the UK finance minister, Gordon Brown, announced that his 'five tests' for British membership had been met – his decision is due by June 2003 – and the public then voted to join in a referendum. UK entry would enhance its influence in the Union, permitting a more central role for Britain's finance minister in critical debates, such as on the future of the European Central Bank (ECB) and economic policy co-ordination. The entry of another large economy would also increase the eurozone's international weight. On the domestic front, the removal of the euro question from the debate about Europe would give the British government greater room for manoeuvre in tackling other EU issues on their merits.

The second scenario would result if Brown announced that the economic tests were not met. The tests could be revisited a few years later, but if they were still not met, the government could not hold a referendum in this parliament, which has to end by mid-2006. During this period, the UK would still try to influence the development of the eurozone from the sidelines. But it would be progressively excluded from key decisions on economic policy as more countries adopted the euro. Sweden and Denmark, the other member-states outside the eurozone, are likely to hold referenda on joining in 2003, while the candidates due to enter the EU in 2004 want to join monetary union as soon as possible after their accession. It would be hard for the UK to oppose the Euro group taking on formal powers if it were the only country outside it. A long period of uncertainty would also reinforce the UK's reputation in many other EU countries as an unreliable partner.

In the third scenario, the UK would opt to remain outside the eurozone, either because the referendum was postponed indefinitely or because of a 'no' vote. A decision not to join would not

necessarily amount to a catastrophe for British-German relations per se. The bilateral relationship might well continue on the same path as before. But the partnership would play only a minor role within the EU, and Germany would lose a potential ally in the eurozone. The euro issue would not go away for the UK – as it has not for Denmark, despite the ‘no’ vote in its referendum held in 2000. But given the ferocity of the domestic debate, a ‘no’ would rule out a re-consideration of membership until well into the next parliament, putting off the issue for a further five years or more.

During that period, the UK’s influence would decline – to its own disadvantage and probably that of the eurozone too. The euro has begun to transform the dynamics of EU policy-making. It will create a hard core of member-states, whose economies are increasingly integrated and whose destinies are intertwined. Since problems in one economy could spread to the others, the members of the Euro group will develop a strong interest in one another’s progress. Decision-making in the Union relies on a complex network of trade-offs between different policy areas, crucial to gaining consensus between the member-states. If one member-state is not fully involved in all areas, it has fewer means of influencing other countries. It cannot be in the inner circle of policy-making.

Even more importantly, member-states do one another favours because of a sense of common involvement. When they embark on a new project, they all share the risks of the enterprise as well as the potential rewards. The UK has always been wary of risky new projects – including the founding of the Union itself and the Schengen agreement, as well as EMU – and usually stayed outside until success was assured. This historical tendency creates distrust among other member-states, many of which have the sense that the UK’s unwillingness to share risks makes it a free-rider on European integration.

So far, the UK has not been marginalised because it has been able to join coalitions within the Union. Progress in European integration is

no longer dependent on the Franco-German alliance, but rather on shifting coalitions that push for progress on particular policies. So even though it is outside the euro, the UK is able to lead on defence and be constructive in other areas like justice and home affairs. This strategy of active bilateral engagement and joining coalitions is probably sustainable over the next few years. But after that, Britain's influence will depend on whether it joins the eurozone. Britain retains its influence today because the rest of Europe believes it is a 'pre-in' for membership, so they give the UK the benefit of the doubt. However, Britain cannot maintain its euro-agnosticism for much longer. Five years from now, the patience of other EU members will have worn thin.

A 'no' vote in a referendum would affect the attitudes of British voters towards greater European integration. It would be much harder for Blair to coax the British public towards acceptance of new policies if rejection of the euro reinforced the 'us and them' mentality of the British towards the rest of Europe.

The UK's 'attitude problem' has repercussions for Germany's European policies, too. German policy-makers have consistently tried to encourage the UK to join monetary union in order to maintain British influence, despite fears in the UK that Germany wants to dominate the eurozone. According to Hans Eichel, the German finance minister:

Britain will have the greatest possible influence in the creation of Europe if it develops, pro-actively, the process of European unity itself ... Whoever does not do [so] will find themselves joining a Europe where the rules have already been set and in which they have had no influence over them.¹¹

¹¹ *Daily Telegraph*, January 17th 2002.

If Germany wanted to eliminate British opposition in key areas like taxation and institutional reform, it would encourage the UK to stay outside the eurozone. Instead its leaders are encouraging Britain to come in, reflecting their

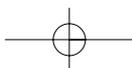
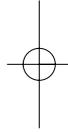
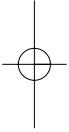
concern to strengthen the cohesion of Europe. Germany does not want to find itself having to work in opposition to the UK.

In many areas of European policy, the UK and Germany are now closer to one another than they are to France or Italy. Their partnership could be crucial to the EU's progress. If the UK were in the monetary union, it would have as much to offer Germany as France does. The UK's decision is thus a vital interest for Germany because it affects the political dynamics of the EU as a whole.

Britain's prolonged isolation from the eurozone would limit the UK's ability to participate in other core areas of European integration. It would also weaken the British voice in EU debates, lessening its beneficial influence in pushing for liberalisation of trade policy, economic reform, enlargement and radical changes in agricultural policy. In all these areas, Germany needs the UK as a full partner.

So long as Britain is outside the euro, and the issue remains sensitive, British politicians and officials are reluctant to discuss in public their views on reform of the ECB or economic policy co-ordination within the eurozone, for example. Yet the Treasury is in a double bind, not able to say much in the domestic debate, but not having a voice in the inner circles of policy-making in the eurozone either.

But the political dynamics could change quite fast if Britain joined the euro. In the institutional arrangements, Gordon Brown would lose his concern to maintain the influence of ECOFIN – the council of economics and finance ministries – against the Euro group. There would be no further need for the informal group of euro members. The British Treasury would become less reticent in expressing its views on how to reform the ECB. It could be more constructive in arguing for economic policy co-ordination. And the UK would find more willing ears in the rest of Europe for its arguments about the need for structural reform, particularly through the Lisbon agenda. Britain's interests would be closer to those of the rest of the eurozone, and its views would have more influence.



6 Can Germany and the UK co-operate in economic policy?

Monetary union is an incomplete construction. There are still many critical decisions to be made about how it will be managed, which have implications for Europe's economic performance over the longer term. We argue that the single currency area would benefit from the UK's presence, as a strong advocate for reform of its policy-making structures. And we suggest that Germany and the UK should construct an alliance to create a better system of monetary policy-making. If two such large economies drove a powerful reform agenda in tandem, they could serve their common interests and also help the eurozone. But they can only do so if the UK adopts the euro.

The EU's treaties are very vague about the running of EMU. They don't clarify who is in charge of exchange-rate policy, they don't say whether changes are required in banking and financial market supervisory systems, and they don't stipulate whether governments should try to harmonise their taxation and spending policies. The treaties set up a framework for policy-making, assigning roles to the European Commission and to ECOFIN. These institutions monitor economic performance and convergence, as well as the member-states' adherence to agreed economic programmes. Likewise, the Stability and Growth Pact calls for sustainable budgetary policies and allows ECOFIN to fine governments which breach the Maastricht treaty's 3 per cent budget-deficit limit. The eurozone countries will spend the next few years deciding exactly what policies are needed to make EMU work, but the UK's voice will be missing from this debate.

Economic convergence

Except for a single monetary policy, Europe has few instruments to deal with a serious economic or financial crisis. Successful management of the eurozone thus depends on effective economic

¹² *Pierre Jacquet and Jean Pisani-Ferry, 'Economic policy co-ordination in the euro-zone: What has been achieved? What should be done?' CER, 2001.*

policy co-operation between governments.¹² How much co-operation is necessary depends partly on how much the economies have converged. The greater the convergence between two countries in a monetary union and the greater their integration, the less active co-ordination is needed to avoid asymmetric economic shocks.

Convergence is thus a critical question for how the currency union will perform. It is also a political question, because economic convergence gives countries more common interests. In this section, we look at the prospects for convergence in the eurozone. And we ask whether the British and German economies have converged sufficiently to share common policy interests.

The Maastricht treaty set out limited convergence criteria that countries had to meet before they could join the monetary union. These comprised exchange rates, short-term interest rates, budget deficits, total net government debt and inflation rates. The treaty deliberately excluded 'real convergence' criteria, such as economic growth and unemployment, as unnecessary for the smooth working of a monetary union. Gordon Brown disagreed and, in 1997, came up with five additional convergence tests that the British economy has to meet before it can join the monetary union.

The most important of the five is whether there is sustainable cyclical convergence between the UK and the other members of the eurozone. The other four tests are more judgmental in nature – flexibility to cope with economic change, and the effects on investment, the British financial services industry and employment. The British Treasury cited insufficient cyclical convergence as the key reason why the UK did not meet the five tests in 1997.

Economists can always disagree about whether the UK economy has converged sufficiently. And commentators frequently claim that the tests are little more than a political device to fine-tune the date for a referendum. Gus O'Donnell – the senior Treasury official charged with completing an economic assessment of whether Britain should adopt the single currency – reportedly stated that economics can never be clear and unambiguous, and that ultimately politicians will have to decide whether the tests have been met.¹³ This was an entirely reasonable observation.

Nevertheless, it is important to focus on the question of whether the economies of the UK and Germany have converged, because that determines how much their interests would coincide if both were in the eurozone. Germany produces one-third of the eurozone's economic output, so it is central to the UK's decision of whether and when to enter. We distinguish between two types of convergence – cyclical and structural.

Cyclical convergence

Mervyn King, deputy governor of the Bank of England, was only half joking when he said that it could take several hundred years to reach a clear judgement about the convergence of business cycles.¹⁴

Nevertheless, there is some evidence that the UK cycle is beginning to move more closely with the rest of Europe than with the US, according to estimates made by Peter Spencer, economic advisor to the ITEM Club.¹⁵ One of the reasons is a structural shift in trade patterns over the past 30 years, so that the EU now accounts for over 50 per cent of total British trade.

¹⁴ *Evidence to the Treasury Select Committee, House of Commons, 2000.*

¹⁵ *The ITEM Club is an independent economic forecasting group supported by Ernst & Young.*

The performances of the British and German economies have also become more similar over the past 20 years, in terms of inflation and growth rates. And the unemployment situation has changed dramatically: until the early 1990s, the UK had a persistently higher joblessness rate than Germany, but the situation has since reversed, with German

unemployment rising and the UK's falling. The apparent synchronisation of the two economies took place against the kind of currency movements which usually reduce the coincidence of business cycles. Since 1999, the pound has appreciated markedly against the euro, while its exchange rate against the dollar has been significantly more stable.

Nevertheless, the volatility in the sterling-euro exchange rate is a serious cyclical problem. Many advocates of British membership of EMU would oppose entry at sterling's recent exchange rates against the euro. Memories of Britain's short-lived membership of the exchange-rate mechanism (ERM) in the early 1990s are still vivid. Sterling entered the system at a relatively high exchange rate of DM2.95, but the British and the German economies diverged in subsequent years. This was largely because of the economic after-effects of German unification, which led to an increase in short-term nominal interest rates in Germany to 10 per cent, and in Britain to 15 per cent, during the final stages of the ERM crisis. If Britain were to enter EMU at an overvalued exchange rate, there is a great danger that history might repeat itself – except that a country cannot exit a monetary union as it can an exchange-rate mechanism. Some currency stability in the run-up to adopting the euro, and a high degree of cyclical economic convergence, are therefore important pre-requisites.

The choice of the entry level for sterling will be crucial for the initial performance of the UK economy inside the eurozone. Some commentators suggest that the present rate, overvalued though it seems to many, is close to the correct rate: the strong pound reflects an adjustment in relative economic performance between the UK and the rest of the EU over the past ten years. Others argue that UK manufacturing – which accounts for about a fifth of British economic output – is uncompetitive at the present rate. There is no simple method of determining the correct entry rate, as it will depend in part on the future value of the dollar.

Structural convergence

While the British and German economies remain very different, some structural convergence has taken place in the past decade. The UK went through a long period of relative economic decline during the post-war period until the early 1980s. Under the Thatcher government, the UK was the first European country to embark on a process of deregulating its labour, product and financial markets, and of privatising state-owned industries. Other European countries have also adopted some of these policies, but much later and in most cases with much greater caution.

Germany's experience was in many respects the reverse of the British one. Germany enjoyed an economic boom in the post-war decades, the *Wirtschaftswunder*, but has experienced a relative economic decline over the past two decades. Nevertheless, it did embark on a programme of privatisation and deregulation, especially in the financial markets, in the late 1980s.

The Schröder government made another effort at structural reform a decade later. It passed a comprehensive tax reform package in 2000, which will lead to an eventual reduction in the top tax rate to 42 per cent and a cap on the total corporate tax rate at just over 35 per cent. The government introduced a modest pension reform package in early 2001, limiting benefits to 67 per cent of final net pay, down from the previous 70 per cent. And it privatised and deregulated some state-owned industries, such as telecommunications and energy.

But Germany has been a slow, reluctant and late reformer. Apart from postal privatisation, where Germany is ahead, the reforms came a decade or more later than those in Britain and were far less radical. The UK's top tax rates were cut to 40 per cent in the 1980s, for example, and its pension reform programme relegated the state pension to a subsistence scheme, encouraging the growth of private pension provision. Moreover, since 2000, the German government has put off other much-needed reforms, including the liberalisation

of labour markets and the removal of the remaining restrictions on shop opening hours.

Germany's failure to reform is one of the reasons why it is languishing near the bottom of the growth league table in the eurozone. There are other explanations too, particularly the cost of financing the integration of the eastern Länder and tight monetary policy during the period following unification. Germany's most recent economic difficulties may also have been affected by the high conversion rate at which the D-Mark entered the eurozone. However, most commentators, including the OECD and the IMF, agree that Germany's relative economic decline is at least partly due to structural problems.

The stark divergence in the performances of the British and German economies is also the result of different economic policy goals and methods. Chancellor Schröder is a careful tactician and he has moved economic reform forward at the fastest speed that he can afford politically. But his party opposed strongly the 1999 Schröder-Blair paper, which was a rallying cry for deregulation and modernisation. The strong political hostility to the paper in Germany showed that there is, as yet, no majority in the country in favour of the adoption of Anglo-Saxon capitalism. A CDU/CSU government under Edmund Stoiber would find it no easier to reform the German economy, and at the time of writing Stoiber has few concrete proposals for doing so.

The consensus over economic policy in the UK remains much more liberal than that in Germany, and this gap limits the potential for a British-German alliance on EU economic policy. The governments of the two countries have split in the past over workers' rights, the role of trade unions and employers' organisations, tax competition and environmental policies. If the UK were inside the eurozone, these conflicts could take on a much wider importance. EMU is intended to operate as an economic union as well as a monetary one – after all, the 'E' in EMU stands for Economic, not European. This unified

economy may not require a common economic ideology, but it does require a minimal degree of compatibility. As long as Germany and the UK remain so divided on issues like social rights and taxation, it is unlikely that they will form an economic policy axis inside the eurozone.

How can these differences be managed? Structural convergence between the two economies would help, while both countries would benefit from tackling some of their respective weak points. Germany needs to try harder at economic reform. A new push will only be possible after the federal elections in 2002, but the next government has to tackle Germany's inflexible labour markets and restricted shopping hours quickly and effectively.

The UK, for its part, needs to acknowledge more readily the weaknesses in its own economic system, especially when it advocates reform of other economies. Britain's social problems, high levels of inequality, low literacy rates and over-stretched public services make the Anglo-Saxon economic model unattractive to many others in Europe. British politicians and officials should take into account economic indicators other than growth and employment when advocating the UK as a model, and address the areas where the country performs badly. If they discussed openly the problems they have encountered in privatisation – such as the difficulties of regulating privatised monopolies – and in education, health and transport, then their voices would find more willing ears in the rest of Europe. Likewise, British policy-makers need to recognise that low skills levels create labour market rigidities in the UK, as well as competitiveness problems in the long run.

British and German politicians should concentrate on the areas where they do have common interests at EU level, such as liberalising trade (particularly in agricultural products) and making the European economy more competitive internationally. The UK has taken the lead in advocating the 'Lisbon process' for economic reform in Europe.¹⁶ Germany has not

¹⁶ Edward Bannerman, *The Lisbon scorecard*, CER, 2001.

always been an enthusiastic participant, and its commitment weakened as the election approached. The two countries could work more closely on pushing forward this process, by working to meet the Lisbon targets themselves and encouraging other countries to do the same.

Monetary policy

One of the key areas of divergence between Germany and the UK is in monetary policy-making. The ECB, based largely on the German Bundesbank model, differs radically from the Bank of England. The two pursue different goals, use different targeting methods and have very different forms of governance. Nevertheless, the ECB is still evolving as an institution and could benefit from the UK's recent experience. After years of boom and bust, Britain has finally found a well-functioning formula for monetary policy-making. Germany and Britain may find little to agree on in this area, but the debates between them could provide a valuable stimulus to reform of the ECB.

Let us look more closely at the areas of divergence, starting with monetary policy goals. The job of any central bank is to provide sufficient liquidity to the economy, while keeping the rate of inflation below a certain level. It thus has to decide what constitutes sufficient liquidity and what is an acceptable level of inflation. The ECB and the Bank of England decide these questions very differently. In the UK, the government sets the target – currently 2.5 per cent for inflation – and the central bank implements it. If the rate of inflation falls outside a band of one percentage point above or below the target, the governor of the Bank of England has to explain why. The Maastricht treaty stipulates only that the ECB has to maintain price stability in the eurozone – which the ECB has chosen to define as inflation of less than 2 per cent. This mandate gives the ECB much more freedom than the Bank of England enjoys.

The Bank of England thus follows a symmetrical inflation target, while the ECB follows an asymmetrical target. For the UK, inflation

can be too low, if it is at a rate of 1.5% or less. The ECB's target stipulates an upper boundary, but not a lower one, except to say that inflation should be greater than zero. Another way of describing the difference is that the Bank of England targets inflation, while the ECB aims for price stability. This difference has not mattered much in practice, however, because the ECB is averse to deflation.

The Bank of England and ECB differ more in their chosen techniques than in their goals. The UK uses a system of direct inflation-targeting, based on an inflation forecast. Policy is set with the goal of keeping future inflation close to the target, on the basis of the forecast. Since the system does not use intermediate goals, such as the money supply, its success hinges on the quality of the economic model used to forecast the rate of inflation. The eurozone members initially discussed such a system for the ECB, but rejected it on the grounds that the statistical data for the new currency area were too uncertain for a reliable forecast. After hard lobbying from Germany, the ECB ultimately opted for the Bundesbank model, based on money supply targets, combined with an element of discretion for the board (like that employed by the US Federal Reserve). The mixed model is less than satisfactory. And the ECB may slowly move towards adopting an inflation target to complement the money supply goal, now that eurozone data and forecasts have improved.

One of the most persistent criticisms of the ECB concerns the lack of transparency and slow speed of its decision-making. This became a major issue in 2001, when the ECB signalled a downward move in interest rates in late March but did not cut rates until early May. During this period, market participants were frustrated at the lack of transparency about how the ECB arrived at this policy decision, although most of them thought the decision to cut rates was right. Policy-making is convoluted because the ECB's Governing Council takes decisions by consensus. The council comprises 12 national governors and six ECB directors, and each governor has a de facto veto. In practice, any member can postpone a decision for several

weeks. Some have suggested that decisions be taken by vote, but others fear that a coalition of national bank governors could outvote the ECB's own representatives.

UK policy-makers fear that these problems would make joining EMU a retrograde step. Since the newly elected Labour government made the central bank independent in 1997, Britain's monetary policy-making has been transformed. The track-record is short, but it is solid, and many UK policy-makers and market participants are reluctant to give up a model which they judge to be working better than the ECB system.

The decision to give the Bank of England independence was not universally welcomed. Some critics asked how central bank independence could be compatible with democratic accountability. To solve this dilemma, the UK adopted a system whereby the Bank's role is limited to the conduct of monetary policy, while the government sets the policy goals and parliament monitors the success of policy. The ECB has to support the economic policy of the Union, but the EU's treaties allow the ECB to set its own definition of price stability. The ECB is accountable to the European Parliament, but it is arguably subject to less scrutiny than the Bank of England.

There are also stark differences in the way the Bank of England and the ECB communicate. The Bank of England publishes a detailed inflation forecast, and also the minutes of its monetary policy committee's deliberations, two weeks after the meeting. The ECB, by contrast, refuses to publish minutes of its meetings, on the grounds that central bankers would come under political pressure if their voting record were known. Instead the ECB communicates through regular monthly press conferences and through its directors' speeches.

Germany and the UK have previously pursued markedly different monetary policies, based on their political traditions and economic philosophies. Given these differences, it is difficult to imagine that the UK would be a consensual partner in ECB policy-making, but it

could be a productive one. If the UK were inside the eurozone, it could offer the best elements of the British experience of the past five years. It would push the ECB towards greater transparency in decision-making. And since some German politicians are dissatisfied with the ECB – both Schröder and Eichel have publicly questioned eurozone interest rates – the UK could help Germany to argue for reforms of monetary policy-making. The UK would be on firmer ground in proposing that the ECB adopt a system similar to the British model, for example, with eurozone finance ministers defining the goal of price stability.

In the run-up to EMU, Germany's hard line on monetary policy caused many of the deficiencies in the present system, because it sought to make the ECB in the Bundesbank's image. But price stability should not be an exclusive goal in economic policy, and there are several ways it can be achieved. Given the previous rigidity of German views on central bank independence, recent signs of greater flexibility from the chancellery and finance ministry are encouraging.

The structure of ECB decision-making should be reviewed at the 2004 inter-governmental conference to prepare for enlargement. The EU should take that opportunity to improve the system by establishing a monetary policy committee. This would comprise a small group of independent members, who would listen to the national central bank governors but make decisions on behalf of the whole eurozone. Such a committee would weaken the ECB's link with national monetary authorities, removing concerns about national prejudices influencing policy. This committee could publish the minutes of its meetings, increasing the transparency and accountability of decision-making.

Fiscal policy

Economic and monetary union need not involve a fiscal union. Sovereignty over fiscal policy remains the prerogative of the member-states. Both the UK and Germany are opposed to major financial

transfers within the eurozone. Both attach a high priority to budgetary stability, and their tax rates have been converging, especially since the implementation of the German government's tax reform package. They thus have similar views on overall fiscal policy, but they have differences over the question of tax co-ordination.

The EU's Stability and Growth Pact provides a framework for fiscal policy, recognising that countries willing to incur excessive budget deficits might do so at the expense of higher interest rates for the entire union. The pact aims to discourage free-rider behaviour by stipulating that countries should achieve a balanced budget over the economic cycle, and it provides procedures through which excessive deficits can be penalised. But the pact is not a replacement for fiscal policy, just a framework for it. Many Germans believe that the single market will require a significant degree of inter-governmental co-operation on matters such as tax policy.

Any co-ordination in taxation policy would be difficult for the UK. The British political establishment is largely opposed to any form of tax 'harmonisation', whereas Germany and several other member-states argue that tax policies should be broadly compatible. Fiscal co-operation does not necessitate setting the same tax rate, they suggest, but it does involve agreement on the definition of the tax base, that is, the definition of the corporate profits to which the rate applies. Finance Minister Hans Eichel has stressed that harmonisation of income tax is not on the agenda. Eichel argued recently that:

¹⁷ *Daily Telegraph*,
January 17th
2002.

It is reasonable to aim at a European agreement of what we tax and how we tax it. I predict that those who do not adjust their tax policy will have a disadvantage in competing in the common market.¹⁷

The fine distinction between tax co-ordination and tax harmonisation is lost on the eurosceptic British press. This area will

remain contentious within the EU, with Germany favouring greater co-ordination and the UK – along with several other member-states – opposed. The sensitivity of taxation issues in the British domestic debate would prevent any move towards tax policy co-ordination, even if the UK joined the euro.

On broader issues of economic policy co-ordination in the eurozone, the UK Treasury tends to be closer to its French counterpart than to the German Finance Ministry. The Germans tend to be sceptical that peer pressure alone is sufficient to bind finance ministers to sound policies, and therefore prefer a rules-based system, whereas the French and British favour the principle of non-binding co-ordination. However, Germany discovered in January 2002 that the Stability Pact's lack of flexibility about budget deficits can be problematic. The German government suffered public censure by the European Commission for running a budget deficit close to the limit of 3 per cent of GDP. The growth in the deficit is not necessarily the result of bad policy, given the German economy's slowdown. However, the Stability Pact is focused on limiting deficits to a narrow range, and allows for a higher deficit only in exceptional circumstances. The pact needs more flexibility, with a stronger qualitative element to take into account the circumstances of the economy in question, and agreed measures of structural as opposed to cyclical deficits.

One way to achieve this flexibility would be to adopt British finance minister Gordon Brown's two fiscal rules. The 'golden rule' states that, over the economic cycle, current spending should be matched by current revenues. This allows borrowing for investment. The 'sustainable investment rule' restricts the stock of government debt to a "stable and prudent" level, which Brown has defined as 40 per cent of GDP.¹⁸ These rules distinguish between current and capital spending, and ensure the sustainability of public finances over the economic cycle. The Stability Pact makes neither distinction.

¹⁸ *HM Treasury, 'Economic and Fiscal Strategy Report', Cm. 3978, June 1998.*

Germany's current leaders should think more imaginatively than their predecessors about how to accompany a commitment to long-term fiscal stability with flexibility on short-term policy management. Their own difficulty with the budget deficit in 2002 provides a further incentive to do so, and perhaps Britain's recent experience could help.

How to improve co-operation within the eurozone

As two of Europe's largest economies, Germany and the UK have a critical role to play in shaping economic and financial policies in the eurozone. The UK's ability to influence these policy debates is significantly lessened as long as it remains outside the eurozone. If Britain stayed out of the euro for a long period, or forever, it would become marginalised as a key player in EU economic policy.

If, on the other hand, the UK were to join the euro within the next few years, it would have significant potential to collaborate with Germany in developing successful economic policies for the eurozone. The two countries share a broadly liberal outlook on economic policy for the EU, and their views are closer than either country is to France or to recent Italian governments. Their economies are converging to some extent, and further structural reforms would increase that trend.

There are also some conflicts. If the UK were in the eurozone, the two countries would almost certainly clash over the conduct of monetary policy, since they have different traditions in goals, methods and institutional set-up. And their governments disagree about whether tax co-ordination is necessary in a monetary union. However, the following steps would help the two countries to reconcile their differences.

1 Action for the UK:

- ★ Take a decision soon on whether the 'five tests' have been met, in order to give the private sector time to prepare for euro membership.

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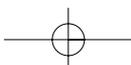
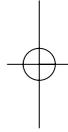
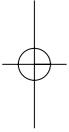
- ★ Acknowledge the failings as well as the successes of the British economic model, and make better progress on the social priorities of the Lisbon agenda.

2 Action for Germany:

- ★ Start work on economic reform immediately after the 2002 election. After fiscal reform, the government needs to focus on welfare and labour-market reforms.
- ★ Favour a more flexible interpretation of the Stability Pact rules that constrain budget deficits, to allow for the ups and downs of the economic cycle.

3 Institutional reform of the European Central Bank:

- ★ Redefine central bank independence, so that the eurozone finance ministers define the goal of price stability. The ECB should remain fully independent in the conduct of monetary policy and its choice of strategy, however.
- ★ The ECB should establish a smaller committee to make monetary policy, the minutes of whose meetings should be published.



7 Conclusions and recommendations

Nearly 50 years after the foundation of the EU, Germany and the UK are still far apart on the principles of European integration. They play different roles in the Union and these have become institutionalised to some extent over the past decade: the UK stands outside the eurozone and the Schengen area, while Germany is less actively involved in defence integration. The gap between their visions of the EU is still great, with the two countries' leaders setting out divergent scenarios for the Union after enlargement. Political cultures and public attitudes are very different too. Germany's European policies are little affected by who is in power. By contrast, a change in government in the UK to the Conservatives (however unlikely at present) would result in a complete shift in EU policy. The British government is also much more sensitive to the views of a eurosceptic media.

Despite these divides, however, there is considerable scope for greater co-operation between the two countries. On the questions of budgetary reform, enlargement, internal security and defence, the UK and Germany face similar short-term challenges, and share long-term goals. Working together on these issues would not only further the interests of both countries, but also make the Union function better.

The days have gone when the Franco-German motor pulled all the other countries along. Germany's relationship with France is more distant than it has been for many years, and Germany has sought other alliances to supplement it. The UK could become a serious partner if it joined the euro and Schengen.

The establishment of an institutionalised relationship to rival the Franco-German duo is probably unnecessary. There are very few areas where the EU can expect grand new initiatives on the scale of the single market or monetary union. However, British ministers should be less dismissive of the value of regular meetings, because they can be important in building long-term partnerships. For example, the British and German foreign ministers – Jack Straw and Joschka Fischer – meet just a couple of times a year, whereas Fischer usually meets his French counterpart, Hubert Védrine, every week. Although Fischer and Védrine may not always have much of substance to discuss, this constant dialogue – echoed at the level of their officials – facilitates a convergence of views and concentrates minds on the resolution of differences.

Germany and the UK could certainly forge coalitions on specific issues. There is scope for closer co-operation on enlargement, as well as reform of the CAP and regional aid, and internal and external security policies. But even a working partnership will be difficult if the UK does not manage to change public attitudes towards the EU. When German policy-makers are asked what one thing the UK could do to help Germany in promoting reforms of the EU, many respond “join the euro”. Even more of them answer “change the British attitude, lose the instinctive suspicion”. Neither of these outcomes would be easy to achieve, and the two are linked. But it is hard to see better prospects for

¹⁹ William E. Paterson, *Britain and the Berlin Republic: between ambivalence and emulation*, *German Politics*, 10/2, pp. 201-223, 2001.

co-operation without some progress towards the euro.

Germany’s position in the EU has been likened to a ‘warm bath’ because of the closeness of fit between German and EU interests. For the UK, however, EU membership has been more of a cold shower.¹⁹ Britain’s fit in the Union is improving as the Blair government finds partners for particular initiatives, for example with Spain on labour market reform.

The scope for joint action with Germany depends in part on the outcome of the 2002 elections. Will Schröder renew his commitment to economic reform if he is re-elected, bringing Germany closer to the UK? What kind of economic reforms would a CDU/CSU-led government under Stoiber put forward? Both Schröder and Stoiber are careful political tacticians, and short-term expediency does not favour large-scale economic reforms at present. The most likely scenario is that Germany will continue with selected pieces of reform, including of its labour market, but at a slow pace. The UK, meanwhile, is in danger of losing influence in economic policy-making if it maintains its euro-agnosticism for much longer. Every year that it stays out of the eurozone, the UK's voice will grow weaker.

Although British-German co-operation will never replace the Franco-German alliance, there is a promising relationship at working level. But to realise that promise, Germany must work much harder on economic reform and the modernisation of its defence forces, while the UK has to adopt the euro and change its attitude to Europe.

Summary of policy recommendations

- ★ Germany and the UK should form the core of an alliance to drive eastward enlargement of the Union over the next two years. Such a push is essential to overcome the objections of interest groups and the reluctance of some other member-states.
- ★ Blair and Schröder should put forward some common ideas on reforming the EU's institutions for the 2004 inter-governmental conference. Their cabinet ministers should meet more regularly to identify common interests and narrow their differences.
- ★ In pushing for reform of the Common Agricultural Policy, Germany must stand firm against the French. The UK and Germany should push for fundamental changes to the EU's

budget. The UK should give up its rebate in return for a fairer overall system. Both countries should advocate the re-nationalisation of the EU's agricultural policies, and a focusing of regional aid on the poorest areas in the enlarged Union.

- ★ Germany needs to step up the pace of reform in its armed forces and contribute more to European defence, both politically and financially.
- ★ The UK should join the Schengen area fully, in order to encourage faster EU progress in justice and home affairs co-operation. Germany should be prepared to compromise with more liberal member-states over migration policy.
- ★ Britain has to join the monetary union. With every passing year it will become more marginalised in European debates on economic policy. Britain could play a positive role in pushing economic reform in the eurozone, and in helping Germany to liberalise its economy. These goals can only be achieved if the UK adopts the euro.

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