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CENTRE FOR EUROPEAN REFORM
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Will Germany rethink defence, too?

by Sophia Besch and Christian Odendahl

COVID-19 has forced Germany to rethink its economic orthodoxy. A similar rethink of its defence and security outlook will take time.

For the last decade, Germany has not lived up to its potential in Europe. Despite its economic and political weight, Berlin was unable to escape 'small nation' thinking. It failed to acknowledge that its export-focused and fiscally austere economic model could not be replicated in the eurozone as a whole. Germany also failed to shoulder its responsibilities for European security, often avoiding difficult decisions. Then came COVID-19, and Berlin's economic approach was turned upside down. Germany's security and defence policy, meanwhile, appears stuck in a rut – but the same forces that led to the shift in economic policy may ultimately drive change here too.

During the pandemic, Germany has provided wide-ranging support for its economy, its businesses and workers, with little concern for increasing its public debt. In early June, it announced an economic stimulus programme worth €130 billion, roughly 3.5 per cent of its GDP, when lockdowns and social distancing were eased. Most importantly, in April, Berlin agreed to a loan-based support scheme for struggling European countries; and then in May, Angela Merkel, together with Emmanuel Macron, proposed a €500 billion recovery fund for Europe involving fiscal transfers to the south (the size of the grants package was reduced to €390 billion in the EU's budget negotiations).

There are several reasons why Germany has changed course. First, this crisis called for an exceptional response. There was little doubt that governments everywhere would need to spend a lot to prop up their economies. The economic debate in Berlin has also moved on. The shift has been driven in part by a generational change, with internationally-educated economists and commentators replacing the old guard; and in part by Europe's experience with the muted recovery from the euro crisis. It helps, too, that the German finance ministry is headed by the Social Democrats (SDP), who are more open to international economic thinking. But most importantly, Merkel decided that this was the best course of action for Germany and Europe. She fought for the European recovery fund within her party, and she led the debate rather than followed as she usually does.

The change in economic policy raises the question of whether Germany can make a similarly dramatic shift in defence policy. Signs that Germany might change its approach have existed for some time. At the 2014 Munich Security Conference, leading domestic politicians called for Germany to shoulder more

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responsibility for defence. Merkel-watchers paid attention to her 2017 'beer tent' speech, when she said that it was time for Europe to "take our fate more into our own hands". The 2018 CDU-SPD coalition agreement allocated large sums to foreign policy think-tanks and research institutes to raise Berlin's capacity to undertake strategic analysis. And opinion polls have shown growing support for Germany to become more involved in defence policy, particularly among younger citizens.

It remains unclear, however, what a paradigm shift in defence policy would look like. Some may deem the NATO target for members to spend 2 per cent of GDP on defence a good indicator. Berlin is much criticised for not meeting this commitment, including by President Donald Trump, who insists that Germany "owes" NATO. Many European countries also feel that Berlin should contribute more to Europe's defence. While there is a growing consensus in Germany to spend more in order to satisfy allies and properly equip the *Bundeswehr*, a certain fatigue about the 2 per cent goal has also settled in. Most consider current plans to 'work towards' reaching the target in 2031 sufficient.

But lines in a budget do not add up to a strategy. Instead of the 2 per cent spending target, Germany's allies should ask Berlin what its priorities are for European security, and what role it wants to play. So far, the response consists of a distinctly German mix of multilateralism and working groups. In the run-up to its Council Presidency, Berlin proposed the 'Strategic Compass', a two-year EU process to assess threats to Europe and develop a strategy to counter them. It has also played a part in conceiving the #NATO2030 process to strengthen political consultation in the Alliance. The long timelines for these initiatives shows that Berlin considers them to be necessary, but not urgent. Such continued rumination on defence policy has been the cause of much frustration in Paris, where many feel that Europe is running out of time to prepare for an era of great power competition.

Like the economic debate, the defence debate in Berlin is moving, albeit more slowly. The security and defence brief was long the preserve of the CDU, whose messaging has been mixed: when Ursula von der Leyen was defence minister, Germany pushed hard for an EU 'defence union' (an ambition that has shrunk considerably in the wash of EU budget negotiations). Under Annegret Kramp-Karrenbauer the defence ministry has stressed Germany's transatlantic ties. Some may hope that a change in US leadership this November would allow Berlin to go back to outsourcing most defence thinking to Washington.

Germany's opposition parties are vying for the next generation of voters. Polls show that German millennials have a much less romantic view of the transatlantic relationship than their elders. They are sceptical of US security guarantees to Europe. Reflecting that scepticism, the SPD is engaged in passionate but almost entirely inward-looking debates about sharing the burden of nuclear defence among NATO members. Younger Germans also want their country's foreign and security policy to prioritise environmental and global health challenges. The Greens are energised by the support of young voters, but their focus remains on climate change and they are unlikely to claim the defence ministry if they enter government after the next elections.

Events have not yet energised the German defence debate in the way that COVID-19 has activated economic discussions, not even, as many expected, the behaviour of Trump. An over-arching vision of European security and Germany's place in it has yet to emerge to replace Berlin's defence policy hedging. Meanwhile, the geopolitical and security implications of COVID-19 are severe. The pandemic will make countries in Europe's neighbourhood and beyond less resilient: long-lasting economic woes will encourage populism and armed conflict, and make them more vulnerable to the influence of countries hostile to European democracies.

Those who want to advance Germany's security debate should be encouraged by the progress economists have made. The shift in German economic policy happened slowly at first, then all at once. As external observers grew frustrated, the domestic debate matured, an alternative vision emerged and was defended in countless internal discussions. Then, when Germany, especially its chancellery, perceived a major threat to Europe's economy from COVID-19, the new approach was put into action. Germany's perception of threats to European security has not reached that critical point yet. Those with Europe's interests at heart should work to ensure that there is a plan ready for when it does.

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To V or not to V

by John Springford

The debate over the shape of the economic recovery continues. But recent medical advances should tilt governments towards continued support for workers and companies, because the pandemic may be over sooner than they had feared.

In a much-discussed – and much-criticised – speech on June 30th, Bank of England chief economist Andy Haldane argued that Britain's post-pandemic recovery had been V-shaped so far. Quoting data from Google, the Open Table restaurant bookings platform and online payments, he argued that the recovery in spending had been faster than the Bank had previously forecast. Haldane had been the only member of the UK's Monetary Policy Committee to vote against further quantitative easing in its June meeting.

Yet data from other countries, such as South Korea and New Zealand, which are further along into their recovery than the UK, suggest that spending on bars, restaurants and public transport has not bounced back completely, even with the virus largely under control. If governments withdraw support for workers and firms too quickly, a wave of bankruptcies and unemployment will follow.

The shape of the recovery will be largely determined by medical and epidemiological progress, so it is difficult for economists to forecast it. Improved testing and contact tracing, alongside social distancing measures, have allowed European countries to ease lockdown measures without significant increases in coronavirus cases. But to achieve a complete recovery, airlines, shops, theatres, cinemas, bars and restaurants will need to reopen fully, which will require a vaccine and improved treatment for the disease.

There are some hopeful signs that vaccines will be available next year, with candidates in China, Germany, the UK and US all generating antibodies in the first stages of human trials (though they have not yet been shown to prevent infection). New treatments have been discovered: an anti-viral drug, remdesivir, has been shown to speed recovery; interferon beta inhalers have been found to reduce the need for hospitalised patients to be ventilated; and dexamethosone, a steroid, cuts the share of patients on ventilators who die by a third. Yet these treatments do not stop COVID-19 from being a highly contagious and potentially deadly disease. Social distancing measures will have to continue until a vaccine is developed and administered to the majority of the population. With luck, that might happen next year, at least in richer countries.

Even those countries that have successfully contained the virus have not seen a full recovery in hospitality and retail. According to Google mobility data, which tracks people going to outlets in these sectors using their mobile phones, footfall is around 5 per cent lower in South Korea than it was a year ago, and 10 per cent lower in Japan and Australia. The numbers using public transport are much worse: footfall in bus terminals and railway stations is down 20 per cent in Japan and 40 per cent in Australia and New Zealand. People are walking, cycling and driving instead, but that does not prevent cafes, shops and bars near railway stations from struggling with depressed revenues. The hospitality, leisure and tourism industries are big employers across Europe, and unemployment will rise very rapidly if government support is withdrawn, as social distancing measures and people's fear of contagion weigh on consumption in these sectors.

Governments have two potentially competing objectives now that the first wave has passed. First, they must continue to support firms that will be viable with a vaccine, but insolvent without one, and keep workers attached to them so that firm-specific skills are not lost. Second, they must seek to reduce support for companies that are able to operate under social distancing conditions, in order to reduce the cost to the taxpayer of supporting the economy and to start the process of redeploying capital and labour. The problem is that it is very difficult to identify which companies fall into which category.

As British journalists Stephen Bush and Ben Kelly have pointed out, the good news on the vaccines and treatment front should, on balance, encourage policy-makers to continue to provide furlough schemes. If the pandemic is over in 2021, they can afford it. Britain's finance minister, Rishi Sunak, announced in July that he would reduce the amount of wage support paid by the government to 60 per cent per worker in September, and that the scheme would end on October 31st. Sunak said that he "will never accept unemployment as an unavoidable outcome", and he may have to revisit his decision to end the furlough scheme in October, especially if the infections start to rise again in the autumn. Under Germany's *Kurzarbeit* scheme, wage top-ups will continue until the end of 2020. And the French government has also been reducing support, to 70 per cent now and to 60 per cent in October, but its scheme will continue into 2021.

To support contact-heavy areas of the economy, sector- and area-specific furlough and loan guarantee schemes may be a solution. Hospitality and leisure outlets could continue to receive support, while it is reduced in sectors that are able to return to normal. Local lockdowns will probably be needed to deal with outbreaks, and their economies will need emergency aid.

It will not be possible, or desirable, for governments to rescue all companies – especially those that were already failing before the pandemic. Some will be unwilling to take on further debt, even if it is largely guaranteed by the state. Germany – and to a lesser extent, the UK – have tried to boost consumption through VAT cuts, to ensure that the economy returns to capacity (within the limit set by continued social distancing). Germany has reduced VAT to 16 per cent (from 19 per cent). The rationale appears to be that this will hasten the recovery in spending, thereby helping unemployed people find work in jobs that are less affected by the virus. Both Germany and the UK have reduced VAT for the hospitality sector to 5 per cent, which may boost bookings, but people may continue to fear infection in restaurants and bars.

Rather than trying to boost consumption, however, governments would do better to target the unemployment problem by giving more support for training and helping people find jobs. That is especially true of the UK, which spends only 0.3 per cent of GDP on such measures, according to the OECD. France spends 1 per cent of GDP, and its spending is far more cyclical than Britain's: it rises more in periods of high unemployment. Governments could also expand funding for care for the elderly and children. The pandemic has exposed the dire state of care homes in many countries, especially for poorer people. Better working conditions and pay would make it easier for homes to find staff. Greater childcare provision would allow more parents to work. Care is labour-intensive, and demand is rising as society ages.

European countries have eased lockdowns without a big rise in infections, but that should not make anyone complacent about the speed of the recovery and the ability of governments to end support for the economy without a sharp rise in unemployment. The virus has not been beaten yet, but governments can be more confident that it will be: that should encourage them to err on the side of activism.

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What future for a 'geopolitical' Europe?

by Luigi Scazzieri

Ursula von der Leyen wants her Commission to be 'geopolitical'. COVID-19 is likely to make this harder, while also underlining its importance.

The fallout from COVID-19 will further destabilise Europe's neighbourhood, at the same time as China, Russia and Turkey are becoming more assertive. The way the EU responds to these challenges will be a test case for whether it can act more geopolitically.

Many of the EU's neighbours will struggle to cope with the economic and social impact of the pandemic, even if COVID-19 has not so far hit most of them hard. Few of these countries are in a position to enact the measures necessary to restart their economies. Many are dependent on income from tourism, which is unlikely to recover fully soon. Others, such as Algeria and the Gulf states, rely on energy revenues, and will suffer from the fall in global prices. Exports will fall, investment will dry up, foreign-currency denominated debt will balloon and remittances from citizens overseas will shrink.

Economic difficulties will translate into reduced government revenue and increased unemployment. This will fuel social strife and give renewed impetus to street protests, like those last year in many countries in the Middle East and North Africa. At the same time, there is no sign that the pandemic is leading to a lull in ongoing conflicts in Libya or Syria. Both people fleeing from conflict and those seeking better economic opportunities are likely to migrate to Europe in large numbers, potentially causing a repeat of the 2015-2016 migration crisis. This could strengthen anti-immigration eurosceptic parties and deepen divisions between member-states, destabilising the Union.

The EU's biggest neighbours, Russia and Turkey, have caused the Union many headaches in recent years. Russia has resisted resolving the Ukraine conflict, and has increased pressure on the EU's eastern member-states. For the first time since the break-up of the Soviet Union, Moscow has established itself as a Mediterranean power, thanks to its involvement in Syria and Libya. Meanwhile, Turkey-EU tensions have risen due to Turkey's drilling for gas near Cyprus, and Ankara's intervention in the Libyan conflict. There is little sign that COVID-19 will push Turkey and Russia to lower their ambitions. Moscow is seeking to consolidate its influence in Libya. Turkey has also established itself in Libya, and shown no indication of wanting to calm tensions in the eastern Mediterranean. Russia and Turkey could use their footholds in Libya to manipulate migration flows to the EU. Moreover, both Moscow and Ankara could become even more assertive if their economic difficulties mount.

At the same time, the pandemic has been accompanied by a more aggressive Chinese foreign policy. Beijing mismanaged its initial response to COVID-19, and has sought to deflect blame. It has threatened countries that have criticised it, and tried to influence public opinion by spreading disinformation and providing high-profile assistance to EU member-states like Italy. China has also taken advantage of the confusion created by the pandemic to tighten its grip on Hong Kong. These moves have sharpened tensions between the US and China: President Donald Trump has blamed Beijing for the pandemic, and stated that he wants to decouple the US economy from China. The US has pressured Europe to support its harder stance, pushing Europeans to exclude the Chinese firm Huawei from their 5G networks.

Whether Trump wins a second term or not, the US will continue to push the EU to take a firmer stance towards Beijing. Democrats agree with Trump that the US needs to be tougher, even if their rhetoric is softer. The EU shares many of the US's concerns. Even before the pandemic the Commission had defined China as a 'systemic rival'. Europeans increasingly agree with the US that they must be more assertive in defending their interests. The Commission wants to make it harder for Chinese firms that receive state subsidies to invest in Europe or bid for contracts. But member-states are unwilling to be as tough on China as the US is: their initial reaction to Beijing's move to curtail Hong Kong's autonomy was relatively muted, with little discussion of measures to deter China from further action. And most member-states remain unwilling to exclude Huawei from their 5G networks, fearing that China may restrict access to its market in retaliation. European opinions of China may have hardened, but the EU seems keen to stake out its own approach rather than following the US. This is likely to lead to increased transatlantic friction.

Europe will need to prevent its neighbourhood from becoming even more unstable, helping the region to deal with the health emergency and weather COVID-19's economic blow. But funding for EU external action and defence programmes in the 2021-2027 EU budget has been sharply reduced compared to the Commission's original proposals – by €15 billion in the case of external action funds. If the EU wants to prevent its neighbours from becoming destabilised, it will also need to take more responsibility for regional security. Europeans can no longer rely on the US: even if Joe Biden is elected the US is likely to prioritise China over the Middle East. In order to be less vulnerable to migration blackmail attempts, member-states need to build a humane and functional migration policy. Finally, Europe will need to defend its economic interests against China, rebalancing its relationship with Beijing and working with the US, without being dragged into a new Cold War.

"There is a risk that the economic crisis and internal divisions will make member-states more inward-looking."

The risk is that Europeans may be too weak economically and divided politically to tackle these challenges effectively. Member-states have become tougher on China, but economic difficulties may deter them from being more robust, for fear of compromising their economic recovery. Member-states may also be unwilling to provide the EU's neighbours with the assistance they need to fight the pandemic and mitigate its economic consequences. They may decide to cut defence budgets, undermining their ability to deter aggression. Finally, Europeans may be unable to agree on how to stabilise their neighbourhood. There is little sign of them converging on a common Libya policy, with France, Greece and Cyprus supporting the rebel General Khalifa Haftar in order to curtail Turkey's influence, while Italy favours the UN-backed Government of National Accord.

Internal political divisions will also continue to weaken the EU. The recovery fund is an important step forward, but it may not be enough to generate a strong economic recovery in the countries hardest hit by the coronavirus recession, such as Italy and Spain. Disillusionment with the EU is likely to continue to fester in many member-states, and the rise to power of a eurosceptic populist government in a large member-state like Italy or France will continue to be a real risk that could sabotage efforts to make the Union more assertive on the global stage.

COVID-19 makes a more geopolitical Commission more necessary than ever. At the same time, there is a risk that the economic crisis and internal divisions will make member-states more inward-looking. But if they neglect the international challenges Europe faces, they will only store up bigger problems for the future.

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CER in the press

Financial Times
21st July
"A free trade agreement increases the scope for bilateral easements," said Sam Lowe of the **CER**, citing side-deals on issues such as financial services and data adequacy that would be easier to strike after a harmonious trade deal with Brussels.

The Telegraph
15th July
"Usually when countries join a strong and stable currency they are trying to import macroeconomic stability and import the credibility of bigger countries," explains Christian Odendahl, chief economist at the **CER**. He says smaller economies, such as Bulgaria and Croatia, can enjoy more stability, intensify trade links and gain political sway by getting a seat at the euro table.

The New York Times
15th July
"Those who see China as a systematic rival or as a potentially hostile state have got it all wrong – they have chosen the wrong target and they are heading in the wrong direction," Ambassador Liu Xiaoming told the **CER**.

Vox
18th June
"[The UK and EU] got stuck on some pretty big and basically political issues," John Springford, deputy director of the **CER**, told me. "In order to unstick it, it's going to require political intervention on both sides. That's why nothing much has happened – and coronavirus matters. Because politicians aren't going to put a lot of effort into this because they're completely consumed with the pandemic."

The Times
17th June
"Brexit will hurt both the UK and the EU, but foreign policy co-operation need not be collateral damage," said Luigi Scazzieri of the **CER.**

Nikkei Asia Review
16th June
Up to 2018, Beijing claimed it had created 327,000 jobs [in Europe], a number challenged by analysts. "A lot involves buying existing European companies," says Ian Bond of the **CER**. "As far as one can tell, such investment may ensure that jobs are not lost, but it rarely seems to create much new employment."

The New York Times
5th June
"It's quite foolhardy to say that because the economic impact of coronavirus will be large that no one will notice the difference," said Sam Lowe, of the **CER** in London. "It's a sophistic argument – that because we've been thrown to the floor, we won't feel another kick."

The Economist
28th May
Mujtaba Rahman of the Eurasia Group, a consultancy, says it is even possible that the June summit may decide to abandon the negotiations, though Charles Grant, director of the **CER**, suggests the crunch is more likely to be in the autumn.

Recent events

28 July
Webinar on 'New Zealand and the changing trade policy context in a post-COVID-19 world' with Vangelis Vitalis

14 July
Webinar on 'The prospects for a deal on the European recovery fund' with Jörg Kukies

8 July
Webinar on 'What does COVID-19 mean for UK trade policy?' with Greg Hands

2 July
CER/Kreab webinar on 'Will there be deglobalisation post-COVID-19?' with Arancha González Laya

15 June
CER/wiiw webinar on 'The UK-EU negotiations in the time of coronavirus' with Gabriel Felbermayr, Sam Lowe and Jill Rutter

3 June
Webinar on 'The geopolitical impact of coronavirus' with Tom Tugendhat

Forthcoming publications

Is the European or US social model more resilient to COVID-19?
John Springford and Simon Tilford

Europe, the US and China: A love/hate triangle?
Sophia Besch, Ian Bond and Leonard Schuette

How economic stability can enhance European sovereignty
Christian Odendahl