

February 2018

The good European?

Why Germany's policy ambitions must match its power

By Sophia Besch and Christian Odendahl

DEM DEUTSCHEN VOLKE

The good European?

Why Germany's policy ambitions must match its power

By Sophia Besch and Christian Odendahl

- ★ Germany's politicians are at last debating the country's role in Europe. They should pursue a clear European agenda that overcomes 'small nation' thinking: Berlin needs to acknowledge that because of Germany's weight, its domestic economic policy has consequences for its neighbours. It also needs to take more responsibility for European security.
- ★ By outsourcing European security to the United States, and closely co-ordinating with France and Britain on European affairs, Germany has long enjoyed the luxury of not having to think strategically about economics or foreign and defence policy. In economics, Germany has been unwilling to give up its partial and self-serving euro crisis narrative; in defence and foreign policy, German politicians have avoided engaging voters in a debate about the country's responsibilities for international security. But the election of US President Donald Trump and, to a lesser extent, Brexit, has focused minds in Berlin: if Europe is to meet its many challenges, Germany needs to question some of its longstanding assumptions.
- ★ This paper examines German political narratives and priorities and outlines an ambitious but realistic strategy in the areas of European trade policy, economic governance, migration management, and defence, looking at Germany's relationships with its main strategic partners.
- ★ First, Germany needs to think more strategically about trade. Under Trump, the US has given up its leadership role in setting the standards for global trade, leaving a void which the EU can fill. Germany has the chance to lead a European push for greater emphasis on social rights, environmental protection, fair taxation and political standards. Berlin needs to develop a trade policy that understands and is willing to use the EU's considerable economic pull for its strategic goals, such as supporting reforms and social standards, or spreading market economics and the rule of law in its neighbourhood.
- ★ Second, Germany must take steps to strengthen the eurozone. Berlin is unlikely to support eurozone reforms like debt mutualisation, or a sizeable common budget. But there are other things it can do: Germany could agree with – and even promote – the idea that fiscal policy could do more to lean against the economic cycle at a national level. Berlin should stop dragging its feet on the banking union and make the capital markets union a political priority. Germany could also raise investment at home and abroad by setting up a public wealth fund.
- ★ Third, after its leading role in the EU migration crisis in 2015, Germany must help develop a long-term European strategy to manage migration. Berlin should be pragmatic about working with Turkey and Libya to stop irregular migration, while also leading the way in ensuring that the use of development aid from European countries is co-ordinated at an EU level. Here, Berlin should go beyond just economic assistance: it could help develop a neighbourhood policy that ties investment support, development aid, full trade access to EU markets, and legal migration routes to clear standards on the rule of law, democracy, social and minority rights.

- ★ Fourth, in light of the deteriorating security situation in Europe's neighbourhood, and in order to become less dependent on the United States' protection, Germany has no choice but to invest in defence and modernise its armed forces. The government must tackle Germany's inability to deploy at scale and the low availability of crucial weapons platforms, as well as the domestically controversial subjects of German arms exports, and participation in NATO's nuclear deterrence arrangements. While Berlin should continue to be a leading voice for the EU's efforts to rationalise its defence market, it should defer to the operational experience of France and Britain and work with them to increase the readiness of European troops.
- ★ Finally, Germany must rethink its working relationships with its main strategic partners. Berlin should not make the mistake of assuming that the Trump administration will be replaced in 2020 by a more traditional US leader, and instead invest in rebalancing the transatlantic relationship. It must enter into a constructive debate with Warsaw about migration, and the rule of law. And it should seize the opportunity that Emmanuel Macron's presidency provides to work constructively with France on eurozone reform.

The German election campaign last summer should have been fought, at least in part, on Europe's future. Over the last few years, many of the main challenges faced by the German government, including the continuing eurozone crisis and migration crises, have come from Europe. But there was hardly any debate about the EU and Germany's role within it. Angela Merkel's comfortable lead in the polls confirmed her instinct that German voters did not want to be bothered with discussions about Europe's future. And despite being the former president of the European Parliament, then SPD leader Martin Schulz also focused almost entirely on domestic issues, except for a few cheap shots at US President Donald Trump and NATO's 2 per cent spending target, and an ill-fated attempt to sound tough on Turkey.

Throughout the tumultuous process of trying to form a government over the last months, German politicians have finally begun to debate Germany's role in Europe. Britain's decision to leave the EU and the election of Trump have focused minds: there is a growing consensus that Germany's economy, its political influence and its security depend on the cohesion and prosperity of its European neighbourhood.

The German conundrum, as former US Secretary of State Henry Kissinger put it, is that Germany is too big for Europe and too small for the world. The European Union is an attempt to solve the 'German question'. Germany is its largest country and sits at the geographic heart of the continent. By embedding its strongest country in common European rules, institutions and decision-making processes, the EU managed to channel German power towards the common European good, and prevent German dominance. The American security umbrella completed the political structure that provided the people of West Germany – and after 1990, all Germans – with the most peaceful and prosperous decades in their history.

There was a downside to this political arrangement, however. By outsourcing German security to Washington, and co-ordinating European policy closely with France, Germany was afforded the luxury of acting like a small nation with little influence in the world: Berlin long refused to acknowledge that its domestic economic policy would have consequences for its neighbours, and abstained from taking responsibility for European security. As globalisation gathered pace after 1980, global security, a stable world economy and a rules-based order became vital German interests. But since the upkeep of those, too, were largely outsourced (again, mostly to the US), Germany was not forced to think strategically about economics or foreign and defence policy.

But that attitude is no longer sustainable. The US and Britain, two key anchors of the West's global political and economic order, are now retreating from Europe. The EU has to develop the strategic reach to protect Europe's security and the global, rules-based economic order. It also needs to take an active part in ensuring a stable world economy.

If Europe is to meet its many challenges, Germany needs to question some of its longstanding assumptions. Germany has to develop a clear European agenda that overcomes its 'small nation' thinking, in both foreign policy and economics. But this agenda cannot consist of an unrealistic laundry list of steps that Germany should, but probably will not take. Rather, it should aim to fit into Germany's political narratives and

preferences, while at the same time serving the European and global good.

This policy brief outlines ambitious but realistic strategies for European trade policy, economic governance, migration management, and defence, and looks at Germany's working relationships with its main strategic partners.

A new European trade policy: Use the weight of the market

International trade is where economic and foreign policy intersect. EU enlargement is a good example: the EU offered former members of the Eastern Bloc access to its lucrative market and later full EU membership, in exchange for economic reform, democracy and the rule of law. The economic pull of the EU helped stabilise an entire region at a critical historical juncture. Despite the current concerns about the rule of law in some of the countries that joined the EU from 2004 onwards, eastern enlargement is one of the greatest achievements of the EU.

“Berlin needs to develop a trade policy that understands and is willing to use the EU's considerable economic weight to achieve strategic goals.”

This strategic dimension is largely absent in German debates about trade policy. Most Germans oppose further EU enlargement in the Western Balkans for example, and the EU's retreat is helping Turkey and Russia gain influence in the region.

The German debate about the US-EU Transatlantic Trade and Investment Partnership (TTIP) was focused primarily on consumer rights and protecting national democracy against an alleged weakening of regulations and standards. Rarely did the discussion concentrate on the wider strategic issue of preserving the soft power of the Western economic model in light of the rise of China, which has its own plans to spread its economic influence through its Belt and Road initiative.¹ Instead, the manifestos of the main parties for the Bundestag elections in September 2017 focused on 'fair trade' for both German workers and developing countries, on social and ecological standards, or simply on the narrow economic opportunities for German companies.

Germany's commitment to multilateral organisations supports the rules-based trade order. Some German critics of TTIP did point out that a mega-regional deal

could undermine the World Trade Organisation (WTO), and all party manifestos supported multilateral solutions to trade. Given Trump's views and his administration's actions – it has blocked the filling of vacancies on the organisation's appellate body – Germany should be a forceful guardian of the WTO and its rules and processes, which remain the bedrock of international trade.

But the WTO is mostly focused on traditional trade issues, such as tariffs, quotas and subsidies. It has made good progress in freeing trade along these lines, even though it is now stuck in the 'Doha round' that started in 2001. But the WTO has been less successful in dealing with the challenges of globalisation in its modern form, characterised by global supply chains and non-tariff barriers, such as divergent standards and regulations, intellectual property rights, and data and investment protection. This is hardly surprising, given the different levels of development and varying ambitions for trade of the WTO's 164 members. Only countries with similar levels of development, similar preferences and close political ties will agree to share such standards, rules and regulations, and be willing to tie their hands and share sovereignty. The EU is the best example.

How could Germany help formulate an ambitious European agenda that fits into its political narrative on trade – economic opportunity, fairness and standards, and multilateralism – and at the same time serves the wider European good?

The narrow economic goals that a small nation would prioritise no longer suffice, nor does overly optimistic support for a form of multilateralism that has largely run its course. Rather, Berlin needs to develop a trade policy that understands and is willing to use the EU's considerable economic weight to achieve its strategic goals, such as supporting reforms and social standards or spreading market economics and the rule of law in its neighbourhood.

At the WTO and in bilateral trade agreements, Germany should push Europe to put greater emphasis on social

¹: For a detailed discussion, see Ian Bond, 'The EU, the Eurasian Economic Union and One Belt, One Road: Can they work together?', CER policy brief, March 2017.

rights, environmental protection, fair taxation and political standards. The US retreat from the international trading system is the perfect opportunity, as it further increases the economic pull of the European market and hence the leverage of European negotiators. The EU could push its own regulatory model more forcibly in bilateral trade negotiations, including the rule of law and transparency, while allowing developing countries the policy space they need to grow their own economies and regulate at their preferred level and speed.

Europe should, though, continue to explore regulatory co-operation with the US in areas of mutual interest, while acknowledging that this will not be possible in all instances. The main benefit of transatlantic co-operation

would be to expose Europe's own regulatory weaknesses. Contrary to European myths that are popular in Germany, in general the US does not have weaker regulations than the EU.² Such co-operation would also help set worldwide standards in the future.

Finally, the US retreat from the 'Trans-Pacific Partnership' (TPP), a 12-country free trade deal, leaves an opening for the EU in Asia. The EU already has bilateral trade agreements with some TPP parties and is considering more. But the result would be a patchwork of different bilateral deals, not a unifying trade deal that others, notably China, could join later. Germany should push Europe and its Asian partners to explore a larger, EU-Asia free trade agreement.

Germany should lead on European economic governance

Macroeconomics is another policy area in which Germans should do some 'big nation' thinking. A familiar line used by German politicians and commentators is that more countries should be like Germany: strong in manufacturing, fiscally prudent and exporting more than they import – which would result in a current account surplus (a surplus of savings over investment).

“Germany should do some 'big nation' thinking on macroeconomics.”

Germans justify their current account surplus by saying that the country should export capital to countries like India, where capital is scarcer. Another explanation, also often heard in Germany, is that ageing countries need to save more than younger countries and thus will inevitably export capital.

The reality is a lot more complex. First, the US had the largest current account deficit before the financial crisis began in 2008, not emerging or developing countries.³ While ageing societies do tend to export savings, demographic differences cannot account for the large net capital flows between countries.⁴ The International Monetary Fund reckons that current account deficits are around 1-2 per cent of GDP higher in the US, France, the UK, Canada and a few others than they should be, given differing demographics and levels of development.

Second, the fact that some countries were deliberately running an export-led growth strategy accounted for large current account surpluses both before and after the financial crisis: Germany, China, the Netherlands and

others used wage restraint, and in the case of China, outright currency manipulation, to drive down domestic demand, which in turn drove up savings and hence capital exports.

Flows of capital, both net (the current account balance) and gross (the underlying capital flows, which are several orders of magnitude higher) can be destabilising. The reason is that capital flows are often fickle and retreat easily during crises, leaving the economy exposed to funding shortages. This is particularly true if, as is often the case, the inflowing capital is not productively invested, but instead goes into government consumption or excessive investment in property.

The large share of capital flows that goes into safe debt instruments can also be destabilising. A prominent example is government bonds. Demand for such safe assets comes from many sources. Emerging economies, after the experience of a major financial crisis in the late 1990s, have aimed to insure themselves against the risk of sudden capital outflows. These countries have run trade surpluses and hoard (mostly highly rated US dollar) bonds, which tend to keep their value even in a financial crisis. The eurozone's crisis countries – Greece, Italy, Ireland, Portugal and Spain – are starting to run current account surpluses, contributing to the large surplus of the eurozone as a whole.

But even Germany's foreign asset holdings are predominantly in safe debt securities and deposits. Households and non-financial businesses in Germany hold twice as much of their wealth in safe assets as their counterparts in the US, the UK, France or Japan.⁵ Germany, one of the economically safest countries in the world, therefore adds to the demand for safe assets abroad.

2: Christian Odendahl and Rem Korteweg, 'Shaping 21st century trade: TTIP, global standards and multilateralism', CER Policy Brief, April 2016.

3: International Monetary Fund, 'External Sector Report', 2017.

4: Menzie Chinn, 'The once and future global imbalances? Interpreting the post-crisis record', Working paper, 2017.

5: Pierre-Olivier Gourinchas and Olivier Jeanne, 'Global safe assets', BIS working paper, 2012.

At the same time, Germany is a forceful proponent of what it considers to be 'prudent' fiscal policy, that is, lower public deficits and debt around the world. Such a policy would reduce the number of available safe assets. But if economically strong governments do not produce enough safe assets, cheaper capital will flow into the private sector and more risky government bonds. This might encourage unsustainable borrowing by governments, banks, businesses and households. Too much demand for safe assets and too little supply by economically strong governments risks sowing the seeds of the next financial crisis.

It is therefore not surprising that hardly any large, rich country or international institution shares Germany's macroeconomic views; and that Germany was repeatedly rebuffed at G20 and other international meetings when it called for more global fiscal retrenchment or defended its large current account surplus on the basis of demographics or 'competitiveness' alone.

“Germans start to feel the brunt of a decade-long, ideologically driven pursuit of deficit-cutting at the expense of public investment.”

Nor has Germany gained much credibility as a potential leader on global economic governance, thanks to its one-sided criticism of what many Germans see as 'ultra-loose' monetary policy by the European Central Bank (ECB) that supposedly causes interest rates for German savers to be low. But interest rates are low worldwide and cannot be forced up by a central bank. What is more, German economic policy itself is partly to blame. German capital exports help drive down interest rates everywhere; German-inspired pro-cyclical fiscal tightening in Europe drove down interest rates further and helped send even more eurozone capital in search of better returns to emerging economies, much to their dismay. In other words, low interest rates are 'Made in Germany', at least in part.

Germany will in all likelihood not contribute much to global aggregate demand, more stable capital flows or a sufficient supply of safe assets. Policies that would increase demand in Europe, reduce the eurozone's growing current account surplus or increase the pool of European safe assets go against the dominant German narratives on economic governance. Finding policies that fit into the German narrative, while at the same time helping the European and world economy, is difficult. But there are four areas in which the next German government could plausibly contribute, if German economists and the press help shift the macroeconomic debate to support the government.

6: Christian Odendahl, 'How the ECB should respond to a German fiscal boost', CER insight, September 2017.

First, most Germans are in favour of higher public investment, and do not want tax cuts or further reductions of public debt. They are starting to feel the brunt of a decade-long, ideologically driven pursuit of deficit-cutting at the expense of public investment. Luckily, Germany's constitutional fiscal rule, which prevents deficits by the government, does allow for somewhat higher spending, and the Social Democrats at least seem to be willing to use the fiscal space to the maximum.⁶ Private investment could also be encouraged, for example through tax breaks on R&D investment, or other forms of investment support by the state, both nationally and in Europe. The agreement between the SPD and CDU to beef up the European Fund for Strategic Investments (EFSI), the so-called 'Juncker fund' that supports European investment, is a good start. If the German economy mildly overheats as a result of higher private and public investment, that would raise wages and German demand for imports, in turn reducing its current account surplus.

Second, the German finance ministry has argued that instead of a sizeable common eurozone budget or European unemployment insurance, which many in Berlin reject, countries should strengthen their national 'automatic stabilisers'. By that term, economists mean public spending and tax policies that automatically vary over the business cycle, counteracting boom and bust. Since Europe's fiscal rules allow much stronger automatic stabilisers, Germany should make a push to strengthen them in all countries. For example, through counter-cyclical tax policies on private investment; through reforming unemployment insurance schemes so that they pay out for longer during recessions; through grants to local governments in times of recession and so forth.

Third, capital flows inside the eurozone should be made a stabilising force. The banking union should fully disentangle the finances of banks and governments, which are currently closely linked: banks finance public debt, and governments are the ultimate backers of banks if there is a financial crisis. This 'doom loop' means that, in a financial crisis, some governments may not be able to bail out their banks, and must turn to the rest of the eurozone for help. Germany has already made a political commitment to complete the banking union, which would make both bail-outs and deposit insurance a European affair; and which would make banks hold fewer of their national government's bonds. Berlin should not drag its feet but rather become the champion of a full banking union. Germany should make a bold offer on European deposit insurance and a common fiscal backstop for the Single Resolution Fund, which steps in when banks are wound up. Germany should tie that offer to a thorough clean-up of the European banking system, especially in Italy; and to tough rules on creditor bail-ins.

Equally, Germany should become a champion of the capital markets union, a set of initiatives designed to shift the European financial system away from lending by banks and towards capital markets, and encouraging banks and businesses to raise capital across the EU. Since German firms do not have funding problems and many family-owned businesses do not rely on equity markets, the capital markets union is not a political priority in Germany. But it should be. A deeply integrated capital and especially equity market would mean that regional economic shocks in Europe are more easily absorbed, lowering the risk of crises and public bail-outs. More private investment across borders in Europe can also be easily folded into a German, export-oriented narrative: private actors, not governments, should bear international financial risks as much as possible.

Finally, Germany should tackle its large savings surplus. To boost consumption, low-income earners need to be relieved of their extremely high tax burden. Germany's labour market institutions, which work well for export-

oriented manufacturing businesses and their workers, leave many services workers without much bargaining power or protection, and have generated one of the largest low-wage sectors in Europe.⁷ And German savers need a low-fee public wealth fund to invest in, managed along the lines of the Norwegian sovereign wealth fund, which could boost equity investments both in Germany and across borders, and reduce German demand for international safe assets.

These four proposals are moderate: they do not include government debt mutualisation. Financial risk sharing through deposit insurance and a resolution fund are balanced with risk reduction, in the form of a banking sector clean up. But these proposals do require leadership by German politicians to shift the debate. Germany is no longer a small or medium-sized economy but the dominant country of the eurozone. It needs to make sure that the eurozone benefits all of the currency bloc's members, and is a stabilising force in the world economy.

Managing migration

The European migration crisis has shaken up the German political system. After the sharp rise in the number of migrants, Germany must help to develop a long-term European strategy to manage migration. The EU is currently pursuing three solutions: support for countries in Europe's immediate neighbourhood and the Union's southern members to deal with refugees; co-operate with 'countries of transit' for migrants from Sub-Saharan Africa or the Middle East on their way to the EU; and address the precarious living conditions that drive people to embark on the dangerous journey to Europe.⁸ How can Germany contribute in ways that fit into its political narratives?

“Berlin's policy towards Ankara has long lacked a strategic outlook.”

First, Germany needs to re-think its relationship with Turkey. Berlin's policy towards Ankara has long lacked a strategic outlook. In 2005, Merkel insisted that Turkey's EU accession negotiations be 'open-ended' because the country was 'culturally different'. In 2015, however, Berlin relied heavily on Turkey to stem flows of migrants and refugees that would have otherwise travelled to Greece and from there on to Germany. As a consequence, Germany has been willing to turn a blind eye to Turkey's human rights violations and increasingly authoritarian leadership. Germany added to its strategic blunders in

the summer of 2017, following a Turkish constitutional reform referendum that brought President Recep Tayyip Erdoğan greatly increased powers – Berlin called for EU membership negotiations with Turkey to be suspended or even ended, and was rightly rebuffed by its European partners.

The West cannot afford to cut ties with Turkey altogether. Turkey is a NATO member with the alliance's second largest army, and an important strategic partner for Europe, not least in dealing with illegal migration. Moreover, ending accession negotiations would completely undermine the influence of pro-European voices in Turkey, and strengthen rather than weaken Erdoğan. Germany needs to distinguish between the current Turkish leadership and Turkey as a country in which many reject Erdoğan's policies.

Europe has both political and economic leverage that it can best use if it speaks with one voice. Berlin should focus its attention on modernising the economic partnership between the EU and Turkey, rather than dwelling on the question of accession negotiations. At the same time it should ensure that the EU remains united in making clear that the policies of the current leadership in Ankara undermine Turkey's standing, power and economic prospects.⁹ Now might be the right moment to revive the idea of a 'privileged partnership' for Turkey, which Angela Merkel floated a dozen years ago. The EU could propose a form of association that depends on

7: Christian Odendahl, 'The Hartz myth: a closer look at Germany's labour market reforms', CER policy brief, July 2017.

8: See also: Luigi Scazzieri and John Springford, 'How the EU and third countries can manage migration', CER policy brief, November 2017.

9: Luigi Scazzieri, 'Turkey and the EU: No end to the drift', CER insight, October 2017.

political reform and offers less than membership but more than current arrangements – in terms of economic integration, aid and political ties.¹⁰

“Germany should lead the debate about the purpose and direction of European development and investment aid.”

Second, Germany should increase its engagement with Libya. To stem the influx of migrants from North Africa to Europe, Berlin has stated its intention to co-operate more closely with Libya and possibly replicate the Turkey deal with the Libyan authorities. But Libya is not under the authority of a single government. A number of armed groups are competing for power, and the UN-recognised government does not have the power to control its borders. The German Bundeswehr participates in the EU's Operation Sophia, which has sought to tackle smugglers and to train Libyan coastguards. But this is a short-term fix. Germany should help to intensify the EU's diplomatic efforts to relaunch political dialogue between Libya's main players, and support the efforts of experienced actors in the regions, such as France. It should also increase its economic assistance to the country. The same goes for other transit countries, like Niger or Chad.

Third, Germany should lead the debate about the purpose and direction of European development and investment aid. It is curious that when it comes to development aid – which is severely fragmented in Europe between several dozen donors – there is little call for ‘more Europe’ in Germany. In this area, it would undoubtedly make sense to integrate policies further or even entirely at the European level, including public

investment banks, and fold that into a broader strategic agenda for trade, investment, development and security. EU member-states collectively provide over 50 per cent of all global development aid, and a targeted and concentrated European funding strategy could maximise their impact.

The ‘Compact with Africa’, endorsed by G20 finance ministers in March 2017, was a first attempt by Germany to lead the co-ordination of development and investment aid. But the compact is mostly a platform to facilitate private investment: African countries draw up plans and reform commitments to encourage private investment, and donor countries and organisations in turn co-ordinate their assistance around a ‘compact’ for that particular country. The idea is reminiscent of Germany's failed idea of ‘reform contracts’ for eurozone countries, in which countries would receive European funds in return for structural economic reform. And the focus on private investment, combined with reform from African countries, is too narrow to serve as an example for the kind of larger, strategic partnerships that Europe needs with Africa.

Assisting economic development is not enough: richer countries may well send more migrants, not fewer, to Europe, when more can afford the journey. Europe should offer comprehensive deals that include investment support, development aid, full trade access to EU markets and legal routes for migration, but also clear standards on the rule of law, democracy, social and minority rights, as well as co-operation on returning migrants. Prior to the refugee crisis in 2015, Germany might not have been ready to lead this discussion. But after its experience in the crisis, Germany should be open for a nuanced and realistic debate about Europe's migration and development policies.

European defence: Invest, engage, educate

Germany punches far below its weight on defence and security matters, and its European allies have long been eager for it to step up its activities in this area. The best way to bring Germany's increasing responsibilities in line with its political narrative of a *Friedensmacht* (power for peace) is first, to take a comprehensive view on security and defence; second, focus on creating a competitive European defence industrial base; and third, engage and educate the public and the government in a sustained strategic debate about Germany's responsibilities.

Under-investment in the armed forces has left Germany with major shortfalls in its capabilities. In 2017, German defence spending was only 1.2 per cent of GDP. And while Germany has committed to raising its defence

spending to NATO's target of 2 per cent of GDP by 2024, this ambition has been met with considerable political resistance. During last year's election campaign, the Social Democrats dismissed the target as kowtowing to Trump and promoting spending for spending's sake. But this argument does not hold: if Berlin aims to become less dependent on the United States and its security guarantee – an objective outlined by then SPD Foreign Minister Sigmar Gabriel in a speech in December¹¹ – more investment in defence is a requisite.

Instead, the SPD and other left-wing parties in Germany support the line that “for every euro spent on defence, one euro should be spent on development aid”. Increasing Germany's development spending, which has

10: Charles Grant et al, ‘Relaunching the EU’, CER report, November 2017.

11: Speech by German Foreign Minister Sigmar Gabriel at the Berliner Forum Außenpolitik 2017, December 5th 2017, in Berlin.

only in 2017 finally reached the UN target of 0.7 per cent of GNI, is necessary. But linking development aid with defence investment won't allow Berlin to circumvent the sensitive debate on hard defence spending forever.

Instead, thinking about defence spending on a European level may help ease the pain of more investment as well as shift the conversation from input to output. Defence is a European task. But EU countries continue to buy over 80 per cent of their defence equipment at home. That leads to costly duplication and less innovation, and presents major logistical challenges in joint training and the production of spare parts.¹² Together with France, Germany has supported and shaped EU initiatives to strengthen defence co-operation and to streamline the European defence industry, while opening up national markets to more competition.

“Linking development aid with defence investment won't allow Berlin to circumvent the sensitive debate on hard defence spending forever.”

The proposed European Defence Fund – a spending plan for EU-wide defence research and procurement of new military technologies – is among the most interesting of these EU projects. It addresses the lack of capabilities that is at the heart of many of the EU's defence travails. But beyond initial support, agreeing on the details of the fund will be difficult for Germany. For example, it is not yet clear how member-states will finance joint capability development in the next EU budgetary cycle. The finance ministry in particular opposes any financing mechanism for common defence plans that would weaken Europe's rules on budget deficits. But Germany should be more flexible: at a time of urgent spending shortfalls, countries that invest in defence should not be penalised by the rules of the Stability and Growth Pact for increasing their deficits.¹³

EU-level co-operation to strengthen Europe's defence industrial base also increases NATO's influence and defence capabilities. NATO remains the only European organisation that has the ability to deploy credible forces to defend European territory. It is Germany's most important defence alliance. Through NATO's 'framework nation concept' (FNC), Germany is leading the effort to co-ordinate joint capability development and to build up multinational troop contingents. In working with France, the traditional advocate of stronger EU defence co-ordination, the next German government should ensure that EU initiatives complement what NATO is already doing.

12: Munich Security Conference, 'European security report: more European, more connected and more capable', November 2017.

13: Sophia Besch, 'What future for the European defence fund', CER insight, June 2017.

Funding and developing defence capabilities is the first step; deploying military forces into conflict areas is the second. But responsibility for two world wars and the under-investment in the armed forces has made Germans reluctant to consider military action as a foreign policy tool. The United States has long provided a security guarantee to Germany, both through NATO's solidarity clause, and through the US protecting Germany's wider security interests, including freedom of navigation in the Gulf of Aden or the South China Sea, or fighting ISIS. This US security umbrella has made it possible in the past for Berlin to avoid facing difficult questions on the use of force. Germans like to think of themselves as pacifists. But being a pacifist country is easy when security is guaranteed by someone else; and German pacifism has often served as camouflage for a reluctance to engage.

When, in spite of these political constraints, Berlin became a leading voice in European defence initiatives after 2014, a fear of a 'Germanisation' of European defence – a focus on institutions rather than military operations – came to shape the way Germany's partners looked at Berlin-driven initiatives. French president Emmanuel Macron is committed to EU defence and the partnership with Germany, but also focused on the practical output: he wants Europeans to be able to deploy troops faster and more effectively and has called for a European Intervention Initiative outside EU structures. Such a formation could also involve non-EU members, like the UK. Germany should take the hint and get on board: a focus on procedural purity is misplaced when it comes to military operations. European defence will suffer if EU member-states do not create ways for the UK to plug in its capabilities.

There are some signs of progress. German policy makers are increasingly aware that because of Germany's economic and political power, both duty and self-interest require it to take on more responsibility for defence. Bundeswehr deployments in Mali, participation in the anti-IS coalition, and the leadership of NATO's multinational battle group deployed in Lithuania mark a sea change for Germany's defence engagement. And the German framework nation structure, to which 19 other NATO nations have already signed up, holds great potential to make European forces more interoperable and to generate a pool of forces that can be deployed in NATO's neighbourhood.¹⁴ But these operations and initiatives can only succeed with sustained German political and financial investment.

To be able to guarantee continuous engagement, German politicians must continue to make the case for the defence dimension of foreign policy to the German public.

14: See for more: Rainer L. Glatz and Martin Zapfe 'Ambitious Framework Nation: Germany in NATO Bundeswehr Capability Planning and the "Framework Nations Concept"', SWP comments, September 2017.

One part of that debate must focus on Germany's lucrative but controversial arms exports policy. Germany is among the top five arms exporters. The incoming government, however, is charting a new course, by banning arms exports to all countries that participate in the war against Yemen. Politicians are beginning to react to a broader public awareness of Germany's role in this field and are increasingly focusing attention on the human rights records of potential buyers. Going forward, rather than coming up with ad-hoc rulings on deals with individual countries, Berlin should advocate for, and follow, transparent and coherent Europe-wide rules for arms exports.

“Berlin must continue to make the argument to the German population that policy towards Russia should include security concerns.”

Germans will also have to have a serious debate about nuclear armament, and Germany's role in European nuclear deterrence. Despite being a host country for US nuclear weapons, there is very little public support in Germany for nuclear deterrence, and attempts to discuss the subject in the past have come to naught. Schulz suggested during the election campaign that as chancellor he would call on the US to withdraw its nuclear weapons from Germany. However unlikely, such statements weaken NATO's nuclear posture and damage Germany's standing in the alliance. Following Trump's election, a CDU parliamentarian suggested there might be a need for a European deterrent, provided by the continent's existing nuclear powers, France and the UK, and possibly co-financed by Germany – but he was quickly dismissed domestically, by officials and analysts. At a time of North Korean nuclear posturing and an increasingly belligerent Russia, however, Berlin cannot afford to abstain from the current international discussion over nuclear armament.

Policy towards Russia is another good illustration of the need for a broader German defence debate. Because of its geographic proximity and close business ties with Russia, Germany has long thought of itself as a broker between Moscow and the EU. But the traditional *Ostpolitik* of pursuing 'change through rapprochement' has come up short in relations with Vladimir Putin's Russia. Russia's annexation of Crimea and the war in Ukraine has forced Berlin to show leadership. Germany has been instrumental in designing and upholding the European sanctions regime against Moscow. And in the 'Minsk process', Germany, together with France, played a leading role in bringing together Ukraine and Russia and brokering the agreements of September 2014 and February 2015. Berlin must continue to make the argument to the German population that its policy towards Russia should include security concerns: any acceptance of Russia's illegal annexation of Crimea would undermine Germany's commitment to a rules-based international order.

According to a 2017 Pew Research Centre survey, while 67 per cent of Germans hold a positive opinion of NATO, with support up twelve points from 2015, 53 per cent of Germans do not believe that Germany should honour NATO's Article 5 and use military force to defend an ally if it is attacked. At the same time, 65 per cent are confident that the United States would come to their aid in any conflict with Russia.¹⁵ And while 71 per cent consider ensuring the security of Germany and its allies the most important task for German involvement in international affairs, only 32 per cent support an increase in defence spending.¹⁶ These positions are unsustainable. It is up to politicians to lead the public on this issue, while at the same time think-tanks and other experts must continue to foster debate with government officials.

Domestic support matters, but Germany can only have a significant impact on the international stage through coalitions and alliances. Like its policy priorities, Germany's partnerships also require a re-think.

Don't go it alone

The two pillars of German engagement with the world are the transatlantic relationship and the European Union. How should Berlin work with the governments in Washington DC, London, Warsaw and Paris to realise its European agenda?

Trump is not the first American president to complain that Germany is over-reliant on American forces and under-spending on defence. Nor is he the first to criticise Germany's enormous current account surplus. But his

scepticism towards NATO and the frosty relationship between Berlin and the Trump administration have led more Germans to question the transatlantic relationship – 56 per cent rate the current relationship between Berlin and Washington as somewhat or very bad.¹⁷ Trump's criticism of Germany's trade surplus has led many Germans to reflexively defend the economic policies that have produced the surplus. Trump's posturing is undermining the US influence on Germany even in areas where Berlin deserves criticism.

15: Bruce Stokes, 'NATO's Image Improves on Both Sides of Atlantic', Pew Research Centre report, May 2017.

16: Körber Stiftung, 'The Berlin Pulse – German Foreign Policy in Perspective', Survey on German Attitudes, November 2017.

17: Körber Stiftung, 'The Berlin Pulse – German Foreign Policy in Perspective', Survey on German Attitudes, November 2017.

Though President Trump will not be in office forever, his election does point to a broader change in America's approach to Europe. Germany and Europe continue to depend on the United States for security, foreign policy leadership, and management of the world economy. But Germany must also invest in Europe's ability to act without US support – in defence, trade, foreign policy and economics. The transatlantic relationship can only be preserved if it is made more balanced by Germany and others investing more.

Co-operation with Britain will be complicated by the country's Brexit negotiations. Economic relations between Germany and the UK, while important, are not Berlin's main concern. Berlin's aim is unity among the EU-27, and to prevent other countries from following the British example. And even if the next German government had a notably softer view on Brexit than other countries, as it has at times been the hope in Westminster, Berlin should not strong-arm the rest of the EU into following its lead. The EU cannot be a vehicle of German domination, or it will lose its appeal to others. That is why Berlin tends to defer to the EU's chief negotiator Michel Barnier on all things Brexit. The coalition agreement between the SPD and the CDU mentions Brexit only once.

“Germany's major parties risk missing a unique opportunity for broader European reform, including on economic governance.”

But Germany cannot afford to shut Britain out of co-operation with the EU, especially in the areas of internal and external security. Berlin should push the EU to grant a special third-country status to the UK that reflects the importance of its contributions to defence and justice and home affairs co-operation. Germany will not countenance any bilateral deals between individual member-states and Britain before an agreement about the future relationship has been reached. Once Brexit negotiations have entered a less fragile phase, however, Berlin should invest in formalising a closer bilateral security and defence partnership with Britain.

Perhaps more challenging to the German government than even the Brexit negotiations will be repairing its relationship with Poland. The current Polish government disapproves of Germany's handling of the migration crisis. It accuses Berlin of forcing its open-border policy on all Europeans with the unilateral decision to temporarily opt out of the 'Dublin regulation', which mandates that asylum-seekers must claim asylum in the first EU country they enter. And it sees the Berlin-supported refugee distribution scheme as an attack on countries' sovereign right to determine who crosses their border. Warsaw is also criticising Berlin for supporting the Nordstream 2 pipeline, which it considers a Russian geopolitical project.

The Polish government's clash with the EU over rule of law issues has also put a strain on the relationship with Berlin. Arguing that the Polish government has undermined judicial independence, the European Commission has proposed triggering Article 7 of the Treaty on the European Union (TEU), which is designed to respond to serious breaches of the EU's democratic values by member-states. The German government, aware of the anti-German rhetoric of the ruling right-wing Law and Justice party (PiS) – which has revived calls for Germany to pay Poland World War II reparations – has been careful not to come out too forcefully against Warsaw. But Germany is in favour of making structural funds conditional on respect for the rule of law, and the coalition agreement between the SPD and CDU states that the rule of law inside the EU should be “enforced more consistently than has been the case.” If the Commission asks member-states to go through with Article 7, Berlin will have to make a decision about how hard to come down on Warsaw in this conflict.

But as Germany is forming its new government, for the first time in years there is a window of opportunity for engagement with Poland. A newly appointed Polish foreign minister, Jacek Czaputowicz, struck a conciliatory tone on his first visit to Berlin, stressing that he did not want the question of reparations to impact relations between the two countries. Berlin must use this opportunity to engage with Warsaw about migration, and the rule of law. Poland will be looking for Berlin to show it remains steadfast in its support of NATO's deterrence against Russia. Reassurances to this effect are likely to help foster a constructive bilateral dialogue.

France remains Germany's most important partner. With French president Emmanuel Macron, Berlin sees an opportunity to revive the Franco-German partnership. 90 per cent of Germans want greater co-operation with France, more than with any other country. Strong political will on both sides has led to a restart of some stalled policy initiatives, including on EU defence and migration. And the coalition agreement struck between CDU and SPD has been framed in Germany as a 'response' to Macron's eurozone reform proposals.

But Germany's major parties risk missing a unique opportunity for broader European reform, including on economic governance. The economic narratives of Paris and Berlin are still miles apart. That does not mean that no agreement can be found. The coalition agreement between CDU and SPD at least commits Berlin to more investment into the EU's budget, and less austerity. The CDU and the SPD say they want to develop the eurozone's bailout fund into a full-blown European Monetary Fund. Between a more activist fiscal policy, a proper clean-up of the European banking system, bold initiatives to complete the capital markets union and a rebalancing of the European economy, there is potential for a grand bargain between the two countries. Berlin should seize the opportunity that Macron's presidency provides.

Conclusion

In order to help lead the EU, Germany needs to develop a positive European agenda in foreign and defence policy, in trade and development, in migration policy, and in economic governance.

This policy brief provides Berlin with an outline: over the next four years, Germany must work closely with France on a pragmatic European agenda focused on output rather than institutional design. Berlin should stand up for its values, but where necessary invest in an interest-based dialogue with its neighbours. Germany needs to develop a new trade agenda that not only considers the economic opportunities and protection of high domestic standards, but also how to use the considerable economic pull of the European market to achieve the EU's strategic goals, such as managing migration to Europe, or fostering democratic development in its neighbourhood.

Berlin needs to understand that Germany and the eurozone cannot continue to export capital in large amounts to a world unable to absorb it. It must manage a still simmering refugee crisis, which risks becoming chronic if the reasons for migration remain pressing. It must invest in the European defence industrial base, as well as its own capabilities and troops. And German political elites must make a continued effort to explain Germany's defence and other international responsibilities to the public.

This agenda will require some uncomfortable self-criticism and at times a re-think of Germany's role and red lines. But most Germans understand that their country cannot go it alone, and that the EU, for all its faults, remains the best answer to Europe's 'German question'. A stable, effective and outward looking Union is in Berlin's best interest. But the EU can only develop if Germany starts to behave like a responsible power, rather than falling back on habitual small-nation thinking. That transformation has to begin in the next four years. In the long-term there is hope, if a new generation of creative, Europe-minded politicians from all parties can take over the reins from the old guard.

Sophia Besch

Research fellow, Centre for European Reform

Christian Odendahl

Chief economist, Centre for European Reform

February 2018