The Franco-German Euro Drama

By Gunther Schnabl

A new act is coming.

France is reeling under the heavy weight of its debt. The International Monetary Fund expects a budget deficit of around €162 billion in 2025, which corresponds to 5.4 percent of GDP. General government debt is expected to climb to €3,470 billion, or 117 percent of GDP in 2025. Prime Minister François Bayrou was ousted by parliament over plans for a €44 billion budget squeeze.

His successor, Sébastien Lecornu, a close ally of President Emmanuel Macron, aimed to find other sources of financing to reduce the budget deficit to 4.7 percent of GDP in 2026 and to the EU-benchmark of 3 percent by 2029. Yet finally he announced he would suspend the planned increase in the retirement age from sixty-two to sixty-four until January 2028 to gain the support of the Socialist party. This further widens the public budget deficit and signals the unwillingness of the French parliament to comply with the Maastricht stability criteria.

Yields on French ten-year government bonds have reached the level of Greece and Italy, which are the most indebted EU countries with debt at 154 percent and 135 percent of GDP. The rating agency Fitch has downgraded France to A+ due to high debt, low growth, and political instability. The interest payments for France will continue to rise, thereby increasing the risk of a new sovereign debt crisis in Europe. What does this precarious situation mean for Germany—which has remained surprisingly calm during the French government debt crisis—and the euro? Looking back helps to project the future.

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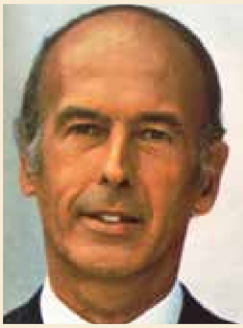
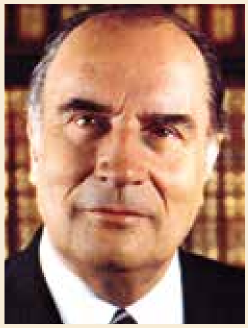
Team France and the Issue of Monetary Policy

French President **Charles de Gaulle** *nationalized the—by then private—Banque de France, making it part of his financial and economic policy.*



For French President **Valéry Giscard d'Estaing,** *the French franc continuously devaluing against the German mark was a thorn in his side.*



French President **François Mitterrand** *called the mark Germany's atomic bomb, lamenting the unparalleled influence of Germany over European monetary and economic affairs.*

EUROPEAN PARLIAMENT

European Commission President **Jacques Delors** *supported German unity, but only in conjunction with a deeper European Community in the form of a monetary union.*

French President **Jacques Chirac** *promised that the euro would become a pillar of stability for Europe.*

ECB President **Jean-Claude Trichet** *saw major imbalances build up within the euro area due restrictive fiscal policy in Germany to keep public debt in line with the Maastricht Treaty, and expansionary fiscal policies in Greece, Spain, Portugal, and Ireland.*

CHRISTIAN LAMBIOTTE/EUROPEAN COMMUNITIES

ECB President **Mario Draghi** *in 2012 restored confidence in the euro with his "whatever it takes" speech during the European sovereign debt crisis.*

When asked why the Commission had often taken no action against France for violating EU fiscal rules, European Commission President **Jean-Claude Juncker** *replied, "Because it's France."*

HISTORICALLY DIFFERENT STANCES ON MONETARY STABILITY

In 1945, French President Charles de Gaulle nationalized the—by then private—Banque de France, making it part of his financial and economic policy, that is, *planification*. A few years later, the U.S. occupying forces established in Western Germany an independent central bank, which later became Deutsche Bundesbank. The stable German mark became the backbone of a dynamic market economy, which turned Germany into the growth engine for Western Europe, including France.

Inflation rates turned out to be significantly higher in France than in Germany. After the breakdown of the Bretton Woods system in the early 1970s, the French franc continuously devalued against the German mark, with the latter—due to its high degree of stability—rising to become the anchor and reserve currency in Europe. As this was a thorn in the side of France, at the end of the 1970s, French President Valéry Giscard d'Estaing pledged more equality in European monetary relations. He urged German Chancellor Helmut Schmidt to launch the European Monetary System (1979–1998), which provided for equal intervention obligations in stabilizing bilateral exchange rates.

Yet while Chancellor Schmidt supported the idea of more exchange rate stability to foster trade integration, he insisted on the independence of the Deutsche Bundesbank. As France had too-high inflation and insufficient foreign exchange reserves to defend the franc against depreciation, the German mark prevailed as the leading international currency in Europe. In the late 1980s, French President François Mitterrand called the mark Germany's atomic bomb, lamenting the unparalleled influence of Germany over European monetary and economic affairs.

MODELED AFTER THE GERMAN MARK

When the Iron Curtain fell in 1989, Mitterrand is said to have urged German Chancellor Helmut Kohl to agree to a common currency in return for France's approval of reunification. Then-French President of the European Commission Jacques Delors supported German unity, but only in conjunction with a deeper European Community in the form of a monetary union. As for the Germans, the mark symbolized the postwar recovery, stability, and credibility, with the Deutsche Bundesbank enjoying high prestige among the population. Chancellor Kohl had to assuage public opinion, which was concerned about inflation.

In Germany, the ECB's ultra-loose monetary policy following the European financial and debt crisis has created large windfall revenues, which have lured the government into inflated social expenditure.


DANIEL NOVAKOVIC/STA

Christine Lagarde


DIRK CLAUS/ECB

Isabel Schnabel

Franco-German Monetary Twins

ECB President Christine Lagarde—now supported by German ECB board member Isabel Schnabel—was not only responsible for the so-called pandemic emergency purchase program worth €1,850 billion. By incorporating climate protection into the European Central Bank's monetary policy framework, she also further watered down the goal of price stability.

—G. Schnabl

As a remedy, the euro was designed after the German mark. The European Central Bank was established in the European treaties as an independent institution, primarily committed to price stability (Article 127 and Article 130 TFEU), and was prohibited from directly financing government spending (Article 123 TFEU). The bail-out of over-indebted countries was forbidden (Article 125). In his Presidential New Year's Message for the euro birth year 1999, French President Jacques Chirac promised that the euro would become a pillar of stability for Europe.

At Germany's request, the Treaty of Maastricht (1993) had laid the foundation for a hard common currency, including fiscal convergence criteria for euro accession. The government deficit for a country wishing to join the euro was required to be less than 3 percent of GDP and government debt less than 60 percent in order to qualify. Using backdoors, however, Italy and Belgium joined the euro with government debt far above 100 percent of GDP. The Stability and Growth Pact (1997) extended the fiscal criteria to the period after euro accession, including penalties for non-compliance. At the same time, the monetary union remained incomplete because the common monetary policy was paired with mostly independent national fiscal policies. No one from Germany has yet been appointed to head the European Central Bank. Instead, there have been numerous

German resignations from the ECB Governing Council, including Jürgen Stark, Axel Weber, Jörg Asmussen, and Sabine Lautenschläger—some in protest.

TRANSFORMED INTO A FRANC-LIKE CURRENCY

So far, two out of the four ECB presidents have come from France: Jean-Claude Trichet (2003–2011) and Christine Lagarde (2019–present). In between, Mario Draghi from Italy held the office. During Trichet's term, major imbalances built up within the euro area due to uncoordinated fiscal policies—restrictive fiscal policy in Germany to keep public debt in line with the Maastricht Treaty, and expansionary fiscal policies in Greece, Spain, Portugal, and Ireland, which were encouraged by buoyant credit inflows from Germany. Unnoticed by the ECB (!), large imbalances within the euro area built up, leading to the European financial and debt crisis, which became the starting point for the transformation of ECB monetary policy along the traditional French central bank model.

To save the euro, the European Central Bank set key interest rates to and below zero, bought government bonds on a large scale, and played an increasing role in the bailout of crisis countries. Via the European Central Bank's Target2 payment system, the Deutsche Bundesbank granted *de facto* zero-interest loans to crisis countries of well over €1,000 billion, while the Banque de France remained on the sidelines. Later on, ECB President Christine Lagarde—now supported by German board member Isabel Schnabel—was not only responsible for the so-called pandemic emergency purchase program worth €1,850 billion. By incorporating climate protection into the European Central Bank's monetary policy framework, she also further watered down the goal of price stability.

The erosion of the German stability culture will not only further undermine Germany's growth dynamics, but also its financial ability to pay for the cohesion of the euro.

Yields on French ten-year government bonds have reached the level of Greece and Italy. What does this precarious situation mean for Germany?

From the early days of the euro, France has been in conflict with the German idea of budget discipline. Since the introduction of the euro in 1999, France has exceeded the budget deficit limit in nineteen out of twenty-six years, while Germany has exceeded the limit in eight years. In the European Commission's compliance tracker for fiscal criteria, France ranks last with 24 percent, behind Italy (30 percent), Greece (38 percent), and (Germany 54 percent). In 2016, when asked why the Commission had often taken no action against France for violating EU fiscal rules, European Commission President Jean-Claude Juncker replied, "Because it's France."

TRANSFERS FOR FRANCE COMING UP?

Meanwhile, the distributional effects of the European Central Bank's overly expansionary monetary policy have contributed significantly to rising inequality in France and thereby to the current political deadlock. High social security expenditure obligations and a public spending ratio of 57 percent of GDP are dragging down growth. In Germany, the European Central Bank's ultra-loose monetary policy following the European financial and debt crisis has created large windfall revenues, which have lured the government into inflated social expenditure. The politically painful reform of the oversized social security system can be only avoided if the exemplary German debt brake is softened, reinterpreted, circumvented or simply abolished. In March 2025, the German parliament opted for an increase of government debt for infrastructure, defense, and climate protection, without any regard for the European debt rules.

To forestall a new debt crisis in the euro area, the French-led European Central Bank created the so-called Transmission Protection Instrument in 2022. It allows the European Central Bank to buy unlimited amounts of government bonds from euro area countries whose interest rates are rising too sharply, "to ensure monetary transmission

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and price stability." In case France does not meet the conditions for TPI during a debt crisis, alternative tools are very likely to be created, as signaled by Mario Draghi in 2012 with his "whatever it takes" speech during the European sovereign debt crisis. The fact that the German government has remained conspicuously quiet in the face of France's fiscal trouble hints at a new act in the Franco-German euro drama. Germany could agree to financial grants by the European Union to France to reduce the deficit, which has become a risk for the euro.

The blueprint could be NextGenerationEU, which is financed by EU bonds (euro bonds) and stabilized Italy and Spain (and the euro!). In return, France could commit to provide nuclear protection for Germany—which Germany urgently needs after the United States under Donald Trump seems to have become unreliable. Since the European Central Bank has EU bonds already put on its list of eligible securities, this would pave the way for the traditional French central bank model on the EU level—and the mutualization of France's debt via common euro area inflation. Then, German economist Wilhelm Röpke's 1964 prediction that "if the states should agree on a common course of monetary policy, those with less monetary discipline would prevail over the few others which had more" will be fulfilled. The resulting erosion of the German stability culture will not only further undermine Germany's growth dynamics, but also its financial ability to pay for the cohesion of the euro. ◆

The stable German mark became the backbone of a dynamic market economy, which turned Germany into the growth engine for Western Europe.