A joint initiative of Ludwig-Maximilians-Universität and the Ifo Institute

CESifo Forum

Spring 2012

Volume 13, No. 1

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CESifo Forum ISSN 1615-245X (print version)
ISSN 2190-717X (electronic version)
A quarterly journal on European economic issues
Publisher and distributor: Ifo Institute, Poschingerstr. 5, D-81679 Munich, Germany
Telephone ++49 89 9224-0, Telefax ++49 89 9224-98 53 69, e-mail ifo@ifo.de
Annual subscription rate: €50.00
Single subscription rate: €15.00
Shipping not included
Editors: John Whalley (jwhalley@uwo.ca) and Chang Woon Nam (nam@ifo.de)
Indexed in EconLit
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European Fiscal Union

European Fiscal Union: What Is It? Does It Work? And Are There Really 'No Alternatives'?

Clemens Fuest* and
Andreas Peichl**

Introduction

The eurozone is atypical as an economic union because monetary policy is decided at the central (European) level while fiscal policy is mostly carried out at the sub-central (member state) level (Bordo *et al.* 2011). Therefore the view is widespread that there are just two options for the future of the eurozone – either it is complemented by a fiscal union, or it will fall apart. This proposition raises a number of questions. Firstly, it is not always clear what is meant by the term 'fiscal union'. Secondly, it is unclear whether a fiscal union would really achieve what people expect from it. Thirdly, it is important to ask whether a fiscal union is really the only chance to save the euro, or whether the currency union might work under a different institutional arrangement.

This paper discusses these questions and provides the following answers. Firstly, we propose five possible elements of a fiscal union, of which three are at the centre of the current debate on fiscal union in the eurozone. Secondly, we argue that fiscal union will only work if political integration in Europe goes significantly beyond the currently planned reforms. Achieving the required level of political integration seems very difficult, if not impossible, at least in the short and medium term. Thirdly, there is an alternative, recently proposed by the Academic Advisory Board of the Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2010 and 2012), which places less emphasis on centralised fiscal policy coordination and instead focuses on financial sector reform and sovereign debt restructuring in the case of fiscal crises.

What is a fiscal union?

In the debate on reforms of fiscal institutions in the eurozone, the term 'fiscal union' plays a central role. However, it is not always clear what exactly this term means and different people use it very differently. In this section, we discuss five possible elements of a fiscal union. It is important to note that a fiscal union may, but does not have to include all five elements.

Element 1: fiscal rules, policy coordination and supervision

The first and most widely discussed element of fiscal union is a set of rules for the fiscal policy pursued by the individual member states and, possibly, rules for other policy areas as well. Elements of this type of fiscal union were introduced when the euro was created, in the form of the so-called Stability and Growth Pact. These rules required member states to balance their budget and to keep the stock of public debt below 60 percent of GDP. Together with these rules a supervision mechanism was introduced, and countries violating these rules were to face excessive deficit procedures that could eventually lead to sanctions.[1]

More recently, new rules have been added to the old ones. The Stability and Growth Pact has been reformed, the Euro Plus Pact extends coordination to policy areas beyond fiscal policy, while policy coordination and supervision has been reformed in the so-called 'Sixpack'. Recently the so-called fiscal compact has been added, yet another set of fiscal rules, which obliges countries signing the pact to introduce balanced budget rules at the national level.

The logic behind this element of fiscal union is that, in the absence of constraints, there is a bias towards excessive debt financing in a monetary union. The cost of running excessive deficits is at least partly

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[1] When Germany and France violated the rules but then prevented sanctions, the credibility of the Stability and Growth Pact was undermined and its enforcement was put into question.

borne by the currency union as a whole. This is because financial difficulties of one member country may threaten the stability of financial markets, create pressures to monetise public debt and interfere with monetary policy. Whether dealing with this requires balanced budget rules, other types of fiscal rules or discretionary policy coordination is a controversial issue. In particular, critics argue that balanced budget rules leave too little room for countercyclical fiscal policy.

A key issue with this institutional setup is the question of what happens if a country does run high budget deficits, accumulates more and more debt and faces bankruptcy, irrespective of whether or not sanctions are imposed. This can happen either because a government does not want to make the effort of cutting back the deficit, not even in the presence of sanctions, or because a country is hit by a severe recession or a banking crisis, so that tax revenues collapse and public spending automatically increases.

It was a severe shortcoming of the initial institutional setup of the eurozone that no preparations were made for this case. The 'no bailout clause', combined with the Stability and Growth Pact, seemed to suggest that a member state that runs excessive deficits would face sanctions. If the member state continued to accumulate debt and faced bankruptcy, the rest of the union would let this state go bankrupt. Although it was clear from the beginning that this scenario was not plausible (see e.g. Fuest 1993), this important issue was ignored until Greece did face bankruptcy and the question of how the eurozone would deal with insolvencies of individual member states could no longer be ignored.

In this context it is important to note that the failure of the Stability and Growth Pact to secure solid public finances in the eurozone is not only due to the fact that the enforcement mechanisms did not work. Even if the member states had agreed to procedures and sanctions against individual member states, it is unlikely that this would have prevented the current government debt crisis. Firstly, financial sanctions would have made the financial situation of the highly indebted countries even worse. Secondly, at least countries like Spain and Ireland had very low public sector deficit and debt levels for a long time. However, they were then hit by sharp recessions caused by the bursting of the real estate bubbles and banking crises in these countries. Even a government with the best intentions to maintain sound fiscal policies could not, and arguably also should not, have prevented public sector budget deficits from increasing sharply in this situation.

What can be learned from this is that even the best fiscal rules and strong enforcement mechanisms cannot rule out that individual member states of the eurozone may face fiscal crises and, possibly, insolvency. Therefore these rules cannot replace arrangements for the case of debt crises in individual member states.

Element 2: a crisis resolution mechanism

Given that insolvencies of member states of a currency union cannot be ruled out, the question is how such crises should be dealt with? Clearly, the simplest way of resolving a debt crisis would be to let the governments of insolvent countries negotiate with their creditors and restructure their debt, as private insolvent debtors normally do. There are two objections to this solution. The first is based on the idea of multiple equilibria in capital markets. As long as investors think that a highly indebted country can repay its debt, interest rates will be low and the country remains solvent. However, if for some reason investor confidence declines, the situation may change, risk premia may shoot up and, at a higher level of interest rates, the country may indeed become insolvent. In such a situation, political intervention may be welfare enhancing if it succeeds in stabilizing the equilibrium with high investor confidence and low interest rates.

The second objection to letting countries always restructure their debt if it becomes unsustainable is that this may give rise to a banking crisis if highly leveraged banks have to write off government bonds.

One way of addressing both issues is to set up a crisis resolution mechanism along the lines of the currently planned European Stabilisation Mechanism (ESM),[2] which is supposed to operate as follows. If a country faces serious financial difficulties and loses access to private capital markets, it may apply for support from the ESM. This will set in motion a crisis resolution process consisting of the following steps. The first step is a detailed analysis of the economic and financial situation to determine whether a macroeconomic adjustment programme may restore the sustainability of the country's public finances. If the answer is yes, the second step is the drafting of a memorandum of

[2] The following refers to the draft treaty in the version made available by the European Commission, see http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf, downloaded 3 March 2012.

understanding specifying the financing needs of the country and the macroeconomic adjustment programme. Financial help provided by the ESM to countries in financial difficulties may be used not just for the financing of general government expenditure, but also for the recapitalisation of banks.

The ESM treaty is less clear about what happens if the analysis leads to the result that a macroeconomic adjustment programme will not restore debt sustainability. The ESM draft treaty includes two provisions, which suggest that in this case a debt restructuring with private sector involvement may be carried out. Firstly, government bonds issued by ESM member states will include collective action clauses, which ensure that a restructuring can take place for all creditors if a majority of creditors agrees. The second provision states that 'adequate' and 'proportionate' private sector involvement will be considered 'in exceptional cases'.

In this sense, the economic role of the ESM is thus twofold: firstly, to avoid sovereign debt restructurings in cases where crises can be overcome without them – cases where countries face liquidity crises, but are fundamentally solvent – and, secondly, to make restructurings possible in cases where they cannot be avoided because countries are insolvent. Making restructuring possible means that the ESM would ensure that funds are available to stabilise the financial sector and prevent the restructuring from triggering a banking crisis.

The economic implications of establishing a crisis resolution mechanism like the ESM are controversial. Critics have argued that the ESM weakens incentives for both policymakers and private investors to behave prudently. Whether this is true is a complex question. A key issue is whether the absence of a crisis resolution mechanism makes bailouts for countries and banks more or less likely. In the presence of a fragile financial sector, a sovereign insolvency is likely to trigger a banking crisis, and therefore governments cannot afford to let it happen. To the extent that a crisis resolution mechanism like the ESM can prevent a banking crisis, it increases the likelihood that sovereign restructurings with private sector participation will take place. In other words, it reduces the likelihood that an insolvent government will be bailed out. The extent to which banks are to be bailed out still remains unclear, but if banks are too big to fail, they will be bailed out anyway.

Things are different if the financial sector is sufficiently robust to absorb a sovereign restructuring without government intervention. In such a situation, the case for a crisis resolution mechanism is much weaker, and its existence is likely to increase moral hazard.

Another critical issue is the decision over whether or not to impose a haircut on private investors in cases where a country applies for help. It is clear that the analysis of the country's economic situation and the sustainability of its debt will be exposed to political pressure. This might give rise to a bias towards the result that a country can restore sustainability after a macroeconomic adjustment programme. The official analysis of the situation in Greece is a good example of this type of bias. One way of dealing with such bias would be to limit discretionary decision-making in this area.[3] For instance, a mandatory haircut for private creditors could be foreseen in cases where countries have received ESM support for a period of two or three years without regaining capital market access.

Element 3: joint guarantee for government debt

A third, widely discussed element of a fiscal union would be a joint guarantee for government debt. This may come in many forms: with or without limitations regarding the duration of the joint guarantee and the amount of debt covered by it, and with different forms of governance regarding access to the funding. Examples of proposals that have been made include the Eurobond proposal or the idea to introduce a debt redemption fund (see German Council of Economic Experts 2011). How is this different to a crisis resolution mechanism? Clearly, this depends on the way in which a joint debt guarantee is introduced. There is a wide spectrum of possible approaches, which can be characterized by the answers provided by the latter to the following questions:

1. How much debt is covered by joint guarantee?
2. Is the joint guarantee introduced for a limited amount of time or indefinitely?
3. Under which circumstances do individual countries get access to funds covered by joint guarantee?
4. If a country fails to service debt under the joint guarantee, how is the cost of servicing the debt distributed among the remaining countries?

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[3] See also Advisory Board of the German Federal Ministry of Finance (2011).

A very restricted approach, which would be close to a crisis resolution mechanism like the ESM, would answer these questions as follows. The debt covered by joint guarantee is limited to, say, 500 billion euros. The joint guarantee is provided indefinitely. The latter reflects that the ESM is set up as a permanent institution. Individual countries would be granted access to debt issued under the joint guarantee if they apply for assistance, as stipulated by the rules of the ESM. If a country fails to service the debt, the losses are distributed among the other member states according to their capital shares in the ESM. In this case, the only significant difference to the ESM arrangements in the draft treaty would be the point that the ESM could not go bankrupt as long as at least one member country services its debt. In contrast, under the current arrangements, each member country guarantees only a specified share of the capital. How relevant this distinction would be in the case of a crisis where some member countries default is an open question.

Of course, this is not what proponents of joint guarantee for government debt in the eurozone have in mind. The most extreme form of introducing joint guarantee would be to extend coverage to all existing government debt in the eurozone, and to do so indefinitely. In this case, access to funding covered by the guarantee would only be relevant for new debt, or, more precisely, debt that exceeds the rollover of existing debt. In addition a rule would be required regarding the distribution of costs in cases where individual member states decide not to service the debt covered by the joint guarantee.

The main objection to concepts involving a joint guarantee is that of moral hazard. Firstly, a joint guarantee for government debt may erode the incentives to maintain sound fiscal and economic policies. Secondly, a joint guarantee could erode the incentives to service the debt covered by the guarantee. While these issues are, obviously, related, they are not the same. We will come back to the moral hazard issue below, where we discuss how the various possible institutional elements of a fiscal union in the eurozone would fit together.

Element 4: fiscal equalisation and other mechanisms for transfers between countries

The elements of a fiscal union discussed so far include elements of transfers only in the scenario where individual member states fail to meet their obligations and do not repay their debt.[4] A further possible element of a fiscal union would involve explicit transfer mechanisms of significant magnitude between countries. Clearly, the current EU budget does include transfers in the framework of structural and regional funds, as well as agricultural policy. However, these transfer mechanisms are essentially unrelated to the functioning of the monetary union. Moreover, with approximately 1 percent of GDP, the size of the EU budget is quite small, so that the magnitude of the transfers is limited.

A standard argument in favour of a fiscal union states that a monetary union should be complemented by a fiscal equalisation scheme to help absorb asymmetric macroeconomic shocks. The underlying idea is as follows. In a monetary union, member countries do not have access to monetary policy to react to a downturn. They can only use fiscal policy, but their room for manoeuvre may be limited if capital markets are sceptical about the solvency of the country. The view is widespread that pressure from capital markets may force countries to adopt counterproductive, pro-cyclical fiscal policies.[5] In such a situation a fiscal equalisation scheme may provide insurance through financial transfers to countries affected by asymmetric negative macroeconomic shocks.

Usually, significant fiscal equalisation schemes only exist in monetary unions with a high degree of political integration, typically federations with a strong central government. Of course, this does not necessarily mean that a fiscal equalisation scheme could not be introduced in the eurozone or the EU. However, one difficulty that does arise is that it is not straightforward to separate the insurance effect of fiscal equalisation, which is crucial for its macroeconomic stabilisation effect, from the income redistribution effect. While a pure insurance mechanism might find sufficient political support, introducing a significant redistribution mechanism would face more resistance. Another issue is that, depending on the type of shock, stabilisation through fiscal equalisation may also delay necessary adjustments in the country hit by the shock.[6]

[4] To be precise, loans from one country to another at interest rates that do not reflect risks of insolvency constitute transfers even if no insolvency occurs.
[5] One should note that this is not easily reconciled with the fact that, in principle, private creditors should be interested in the fiscal policy that has the highest chances of restoring the economic stability of the country. Of course, things may be complicated by heterogeneity of interests between old and new creditors.
[6] For a thorough debate of these issues – see e.g. von Hagen and Kletzer (2000).

Element 5: a larger EU budget and European taxes

Finally, a fifth possible element of a fiscal union would be an extended government budget at the EU level, combined with an EU tax.[7] Such an increase of the central government budget would require a significant shift of policy responsibilities to the European level, which raises many questions. From the perspective of macroeconomic stabilisation in the monetary union, the key issue is whether this would improve fiscal shock absorbers in the presence of asymmetric shocks. In order to achieve macroeconomic stabilisation, contributions to the central budget would have to decline automatically in the presence of negative shocks, while central government expenditure in the country would ideally increase.

Currently contributions of the member countries to the EU budget are approximately proportional to GDP. Since the size of the EU budget is only just over 1 percent of GDP, and given that its expenditure in individual member states is mostly unrelated to macroeconomic conditions, the amount of fiscal stabilisation it could offer is quite small.

There are, in principle, various ways of reinforcing the stabilising effects of the budget. Firstly, the EU could take on tasks involving more countercyclical revenue and expenditure like, for example, unemployment insurance. Secondly, the EU could rely on EU taxes or be more directly linked to the tax revenues of the individual member states (see Bargain *et al.* 2012). There is recent evidence that tax revenue collection is very sensitive to the business cycle, more sensitive even than tax bases (see Sancag *et al.* 2009).

How can these elements be combined?

In the current political debate on reforming fiscal institutions in Europe, attention focuses largely on fiscal rules and supervision, the ESM as a permanent crisis resolution mechanism, and the possibility of joint guarantees for government debt like, for example, Eurobonds (elements 1, 2 and 3 described above). Proposals to set up a fiscal equalisation scheme, to enlarge the EU budget or to introduce European taxes (elements 4 and 5) play a lesser role. In this section, we therefore focus on the former, but we will come back to the latter further below.

[7] For instance, Cnossen (2002, 466) argues in favour of "a federal government with real taxing powers and financial leverage over the Member States to mitigate adverse effects that might arise from Member State tax policies".

How are fiscal rules and supervision, the ESM, and joint guarantees related? As pointed out in a recent report by the Advisory Board of the German Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2012), in a rather fundamental sense, fiscal governance of the eurozone will only work if the institution that guarantees government debt also controls the policies determining government debt.

Joint guarantee for government debt requires centralised fiscal policy

In the extreme case of an unlimited joint guarantee for government debt in the eurozone as a whole, it is evident there would have to be strong centralised control over the level of debt each member country is allowed to take on. In this respect, fiscal rules (element 1) and a joint guarantee for government debt (element 3) seem to be complementary. Unfortunately, the degree of control required would go far beyond the fiscal rules and supervision mechanisms as currently considered for Europe. In the absence of this centralised control, however, a severe moral hazard problem would arise. Individual countries would have incentives to neglect sound economic policies when they are inconvenient, incur large deficits and, if this leads to financial difficulties, let other countries pay for their debt.

In its 'Green Paper on the Feasibility of Introducing Stability Bonds' published in 2011 the European Commission acknowledges that the moral hazard issue is of central importance and discusses various ways in which this could be addressed. One possible approach is to rely on tighter policy coordination and supervision. In addition, the Green Book suggests that, while interest rates on bonds covered by the guarantee would obviously be uniform, a rule could be introduced which would imply that countries with high deficits or debt levels pay an interest premium, while countries with solid fiscal policies are granted a discount. This is similar to the idea of introducing financial sanctions against countries that violate deficit rules.

Moreover, the Green Book includes proposals to ensure that bonds covered by joint guarantees will be of higher quality than 'normal' government bonds. Firstly, collateral could be required for bonds issued under the joint guarantee. The collateral could take the form of gold, cash or shares of public companies. Secondly, the bonds could be given seniority status relative to other forms of government debt. Thirdly, the revenue from specific taxes of the debtor countries

could be earmarked to service the debt, so that some tax revenue would automatically be absorbed by the debt service.

Unfortunately, these safeguards are less convincing than they may seem at first glance. Firstly, if governments had sufficient collateral, there would be no need for joint guarantees. Secondly, and more fundamentally, the trouble is that it is practically impossible for ultimately sovereign member states to commit to the implementation of safeguards like, for instance, the earmarking of tax revenue sources. Clearly, in a situation of financial distress, countries would have strong incentives, and possibly also good arguments, to revise earlier decisions about earmarking or collateralisation.

Of course, joint guarantees could be made conditional to member states complying with contracts on safeguards like those proposed in the Green Book. However, in that case the joint guarantee would not achieve its objective, which is to convince investors that the debt will be paid back even if things go wrong in the country which issued the debt.

Effective fiscal governance is difficult to achieve and requires far-reaching political integration

Ultimately, effective control over national economic policies and an effective collateralisation of government debt require that member states give up political sovereignty. Even if they were willing to do so, institutions would be required that would have the legitimacy to replace decision-making at a national level. This can only mean fully developed democratic institutions at the European level. In other words, the eurozone or the EU would have to take an institutional leap towards a federal state, something like the 'United States of Europe'; and even this might not be enough. Many federal states struggle with the issue of fiscal stability of sub-central governments, and a joint guarantee for the debt of sub-central government is the exception, rather than the rule. For instance, in the United States, no such joint guarantee exists, and insolvencies of municipalities or even states occur, as the example of California shows.

An alternative strategy: focus on decentralised responsibility and financial sector stability

The alternative to the creation of a fiscal union would be to maintain a set-up whereby the individual member states are ultimately responsible for fiscal policy and public sector debt. This was the intended set-up for the currency union when it was created. Clearly, this set-up can only work if it is ruled out that one member state is bailed out by other member states. In the case of the current crisis, this 'no-bailout rule' was violated, mainly because the financial sector was not robust enough and too exposed to government debt to absorb a sovereign insolvency. In order to prevent this from happening again, regulation of the financial sector would have to be changed to make the sector much more robust. This would require, among other things, much stricter capital requirements and changes in the risk rating regulations. Clearly, the risk rating of government bonds could no longer be zero. Banks investing in government debt would have to provide sufficient equity, and they would be required to diversify their government bond holdings. If that can be achieved, an orderly debt restructuring can take place if a member state cannot repay its debt without (big) risks to the financial system.

This would have a number of advantages. Most importantly, financial markets would set better incentives to limit government debt. A key reason for the failure of international capital markets to differentiate sufficiently between member states according to the state of their public finances was that investors could expect that countries would receive help if they faced financial difficulties. The no-bailout rule was not credible, and a sufficiently robust financial sector would restore its credibility.[8]

There are basically two objections to this proposal. Firstly, one can argue that the financial sector will need time to adjust to the new rules. This would suggest that a transitional regime is needed. Such a regime would include a crisis resolution mechanism that could be phased out or reduced in size and scope after a number of years. Secondly, the proposal does not address the concern that a monetary union may need fiscal shock absorbers. However, elements 1–3 discussed in the second section do not include this feature either. It is true that a monetary union without union-wide, fiscal shock absorbers requires low levels of government debt and deficits, so that individual member states have room for expanding government debt if a severe crisis occurs. This suggests that bringing down government debt levels to create more room for national fiscal policy in the event of a downturn could be essential. Again,

[8] See Advisory Board of the German Federal Ministry of Finance (2010).

this will take time. In addition, a large degree of wage and price flexibility is required. Clearly, reforms in labour markets, social insurance systems and other areas are necessary for this.

Conclusion

Given the widespread view that the eurozone can only survive if it is complemented by a fiscal union, we have discussed five possible elements of such a fiscal union. We argue that the concept of fiscal union will only work if political integration goes significantly beyond the current state of affairs, and probably far beyond levels that would currently be supported by European citizens and voters. Clearly, there is a danger that the process of fiscal policy governance in the eurozone remains weak and ineffective, while at the same time joint guarantee for government debt spreads. This could lead to a situation whereby safeguards for responsible fiscal policy-making are undermined.

In this paper we have argued that the eurozone is not doomed without fiscal union. A different approach is possible, which preserves decentralised responsibility for government debt and focuses on the reform of the financial sector. There is no guarantee that this would be enough to make the currency union work smoothly, but the concept of preserving decentralised responsibility for public debt does have the advantage that it does not rely on achieving a degree of political integration in Europe that seems far removed from anything that can realistically be achieved and find democratic support in the near future.

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Can the Eurozone Develop into a Well-functioning Fiscal Union?

Lars Calmfors*

The sovereign debt crises have demonstrated clearly the inadequacy of the earlier system of economic governance in the euro area. Parallel with the acute crisis management, far-reaching reforms of the rules system have been instituted. These include the new regulations adopted in the so-called 'Six-pack' in November 2011 based on earlier proposals from the European Commission and the van Rompuy Task Force.[1] The latest addition is the intergovernmental treaty on a fiscal compact agreed in March 2012 ('Treaty on Stability, Coordination and Governance in the Economic and Monetary Union').[2] This article discusses whether or not these reforms are likely to work.

The earlier rules system

The Treaty on the Functioning of the European Union (TFEU) stipulates that EU institutions and member states' governments 'shall not be liable for or assume the commitments' of other member states' governments (Article 125, the so-called *no-bail-out clause*). Article 123 rules out monetary financing of government deficits by both the ECB and the national central banks.

There were always doubts that these provisions would not bind in a full-fledged sovereign debt crisis, as there would then be strong incentives for both governments and the ECB to try to prevent the transmission of financial shocks through bail-outs of member states, as indeed has proved to be the case. These fears were the main motivation for the stipulations in the Treaty on a *deficit ceiling* of three percent of GDP and that consolidated government gross debt shall not exceed 60 percent of GDP, or if it does, that it shall be 'sufficiently diminishing' and approaching the 60 percent level 'at a satisfactory pace'. These stipulations were backed up by the stability pact, which specified a process for dealing with breaches of the rules (Calmfors Commission 1997; Stark 2001). The original pact also introduced a medium-term fiscal objective (to be interpreted as an objective for the cyclically adjusted fiscal balance) of 'close to balance or in surplus'.[3]

The Pact has both a *preventive* and a *corrective* arm. In the preventive arm, countries in the euro area are obliged to submit *stability programmes* explaining whether or not developments are in line with budget targets to the Ecofin Council (The Council of Ministers in its composition of finance or economics ministers), which together with the Commission evaluates the programmes.[4] The corrective arm consists of the *excessive deficit procedure*. If a member state is judged by the Ecofin Council to have an excessive deficit, it can issue a *recommendation* (and at a later stage a *notice*) to the state to correct the excessive deficit.[5] If both a recommendation and a notice have been given, but not been followed, the TFEU allows for sanctions: first non-interest-bearing deposits and later fines.

Obviously, the governance system in place before 2008/2009 was not sufficient to prevent the fiscal disasters that have occurred in some eurozone countries. Even before the financial crisis struck in 2008 there were already a large number of breaches of the rules: in 45 out of 177 possible cases there were either deficits exceeding three percent of GDP or debt ratios exceeding 60 percent of GDP that were not falling (Calmfors and Wren-Lewis 2011), yet no sanctions were imposed. The most flagrant breaches occurred in

* Stockholm University. I am grateful for helpful comments from Anna Larsson, Assar Lindbeck and Lars Lundberg.

[1] The Six-pack consists of Regulations 1173–1176/2011 of the European Parliament and of the Council, Council Regulation 1177/2011 and Council Directive 2011/85/EU.

[2] See also European Council (2012).

[3] The original stability pact was set out in Council Regulations 1466/1997 and 1467/1997.

[4] EU member states that have not adopted the euro instead submit so-called *convergence programmes*.

[5] There must be a formal Council decision that a member state has an excessive deficit for the excessive deficit procedure to be opened. It is not enough for the fiscal deficit to exceed three percent of GDP, as there is an exceptionality clause allowing such deficits "when resulting from an unusual event outside the control of the member state concerned and with a major impact on the financial position of general government, or when resulting from a severe economic downturn" (Regulation 1466/1997).

2002–2005 when the excessive deficit procedures against Germany and France were halted in clear violation of the stipulations in the stability pact. To *ex post* justify these violations, the pact was watered down in 2005. The revision opened up possibilities for the Ecofin Council to extend the deadlines to correct excessive deficits in the case of 'unexpected adverse economic events with major unfavourable consequences for government finances' based on considerations of a set of vaguely defined 'other relevant factors'.[6] Whereas the original pact envisaged sanctions in the form of interest-free deposits after three years of excessive deficits and fines after five years, the maximum time limits for these measures were subsequently widened to six-seven and eight-nine years, respectively (Calmfors 2005).

The problems with the earlier rules

One can identify a number of problems with the earlier rules that either precluded their use or rendered them ineffective. A first problem was the *atomic bomb* character of the sanctions once they were to be applied: they would then strike with full force instead of being gradual (Calmfors 2005). For a member state with a deficit of above six percent of GDP the initial deposit (and fine two years later) would be 0.5 percent of GDP (the maximum sanction that could be used). For deficits between three and seven percent of GDP the deposits and fines would even be front-loaded, that is larger in the beginning than later. This is because the deposits (fines) consist both of a variable component (0.1 percent of GDP for each whole percentage point excess of the deficit ratio above three percent of GDP) and a fixed component (0.2 percent of GDP), where the variable component is applicable in all years in which there are deposits (fines), whereas the fixed component is applicable only in the first year with a deposit (fine). This atomic bomb character of the sanctions is likely to have acted as a strong disincentive to use them in much the same way as it has been found that labour market administrations shun away from using sanctions in the form of loss of unemployment compensation against the unemployed not searching effectively for jobs if the sanctions are too harsh (OECD 2000).

Another problem has to do with the *pecuniary* nature of the sanctions. A fine in the case of an excessive deficit in a member state will exacerbate its deficit problem. This could make policy makers reluctant to apply this sanction. It could also be difficult to explain to the general public the logic of worsening the fiscal situation of a country with a large deficit in this way. Similarly, the stipulation that the proceeds from fines would be distributed among the eurozone countries not suffering from deficit problems may have contributed to problems of legitimacy for these sanctions.

Sanctions could only be applied in the case of violations of the deficit criterion, but not in the case of breaches of the debt criterion. Although it was recognised that an increased emphasis ought to be put on the *debt criterion* when the stability pact was revised in 2005, this was not backed up by any sanction possibilities. The result was insufficient incentives for countries with high debt levels to reduce them.

A further obstacle to a stringent excessive deficit procedure was that each new step (including the use of sanctions) required a discretionary decision in the Ecofin Council with a qualified majority in favour. This was in direct contradiction to the original German proposal on the stability pact, which envisaged automatic sanctions instead (Stark 2001). This might not have been a great problem if violations of the fiscal rules had been confined only to a single country. However, when several countries breached the rules simultaneously, as was the case in 2003–2005 when France, Germany, Italy and Portugal all violated the deficit criterion, these countries could collude and easily form a blocking coalition.

The fact that all decisions in the excessive deficit procedure are *political* ones taken by the ministers in the Ecofin Council is also a problem in itself. Every finance minister will realise that sanction decisions are a repeated game and is therefore likely to act strategically. Since he/she may also end up with an excessive deficit that risks being sanctioned in the future, lenient treatment of current 'sinners' can be regarded as an investment in lenient treatment of oneself in a

[6] These 'other relevant factors' included: 'potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster R&D and innovation' as well as 'fiscal consolidation efforts in good times, debt sustainability, public investment and the overall quality of public finances'. In addition, consideration should be given to 'any other factors, which in the opinion of the member state concerned are relevant in order to comprehensively assess in qualitative terms the excess over the reference value'. These 'other factors' were exemplified with budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has had a detrimental effect on the growth and fiscal burden of a member state. Arguably these formulations could always be used to justify an extension of the deadlines for correcting an excessive deficit. The revisions of the stability pact were formulated in Council Regulations 1055/2005 and 1056/2005.

similar situation. This is bound to cause reluctance to punish one's peers too harshly.

The earlier rules system did not pay enough attention to developments in 'good times'. There were no direct incentives for fiscal restraint in booms. The incentives were only indirect in the sense that contractive fiscal policy in booms would lower the risk of violations of the deficit ceiling in a subsequent downturn: hence the reward would come first in the future, and perhaps may not even then be reaped by the current government. Ireland and Spain provide clear examples of how unsustainable booms sowed the seeds of future disaster. Although there were fiscal surpluses in both countries before the financial crisis erupted in 2008, fiscal policy was not contractive enough, with the result that the economies overheated. When the overheating came to an end with asset price declines, bank failures and shrinking tax bases, large fiscal deficits appeared.

The large revisions that have been made of earlier government deficit and debt data for Greece have highlighted significant scope for concealing unfavourable fiscal developments through the falsification of official statistics.

A final deficiency of the earlier EU governance system was the obvious *disconnect* between the fiscal policy discussion at the European level, and its counterpart at the national level. In many countries, the two discussions seem to have been very far apart. For example, the stability programmes delivered to the EU led a life of their own as *ex post* accounts, rather than being integrated as an input in the national policy process, which in most countries has been little influenced by the discussion at the EU level (Calmfors 2005).

The reforms of the governance system

One way of evaluating the reforms of the eurozone's governance system is to examine to what extent they address the problems discussed. The upshot is that they do so to a considerable extent, but that it is still an open question as to whether the changes are sufficient.

A clear improvement is that, in the future, sanctions can be imposed *earlier* and in a more *graduated* way. A sanctions option – involving an interest-bearing deposit of up to 0.2 percent of GDP – has now also been introduced into the stability pact's preventive arm, which seeks to ensure that eurozone countries fulfil their medium-term targets (targets for the cyclically adjusted fiscal balance) of budgets 'close to balance or in surplus'. This sanction can be used when a member state "deviates significantly from its medium-term budgetary objective or the appropriate adjustment path towards that objective and fails to correct the deviation" (Regulation 1173/2011). If such an interest-bearing deposit has been lodged and the Ecofin Council later decides that the country in question has an excessive deficit, the interest-bearing deposit can, at that point of time, be transformed into a non-interest-bearing deposit. Such a deposit can also be decided in connection with an excessive deficit decision in cases of "particularly serious non-compliance with the budgetary policy obligations laid down in the stability pact" (Regulation 1173/2011). In addition, non-compliance with a Council recommendation to correct an excessive deficit can lead to a fine. Both the non-interest-paying deposit and the fine can amount to maximum 0.2 percent of GDP.

The changes have added a continuum of earlier and milder sanctions to the previously existing ones. The more graduated sanctions increase the probability that they will be used. The circumstances motivating extensions of the deadlines in the excessive deficit procedure have also been circumscribed.[7]

The interest earned by the Commission on deposits and fines collected should no longer be distributed

[7] The formulations regarding 'other relevant factors' that should be taken into account in decisions on the extensions of deadlines for correcting an excessive deficit described in footnote 6 have become more demanding. They shall reflect (a) the developments in the medium-term economic position, in particular potential growth, including the various contributions provided by labour, capital accumulation and total factor productivity, cyclical developments, and the private sector net savings position; (b) the developments in the medium-term budgetary positions, including, in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks; and (c) the developments in the medium-term government debt position, its dynamics and sustainability including, in particular risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government (Council Regulation 1177/2011). A comparison with the earlier specification of 'other relevant factors' described in footnote 6 shows that a number of factors likely to restrict the scope for deadline extensions have been added. The examples of 'other factors', which in the opinion of the member state concerned could be relevant, has been reformulated to 'financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between member states in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances'. This also seems to limit the scope for deadline extensions.

among the other eurozone countries, but instead be assigned to the eurozone's rescue funds (at present the European Financial Stability Facility, in the future the European Stability Mechanism). One would expect this use of the proceeds to be regarded as more legitimate by many citizens. This might also increase the willingness of politicians to use the sanctions.

A remaining problem is, however, the *pecuniary* character of the sanctions. It may still be the case that many citizens as well as politicians object to exacerbating an excessive deficit problem in a country by forcing it to pay fines.

Another change likely to increase budget discipline is that the stipulation that *government debt* exceeding the reference value of 60 percent of GDP should be 'sufficiently diminishing and approaching the reference value at a satisfactory pace' has now been operationalised: the differential with respect to the reference value should have decreased over the previous three years at an average rate of one twentieth per year. Sanctions can be used if this requirement is not met (Council Regulation 1177/2011).

Voting rules in the excessive deficit procedure have also been changed. This has been done in two ways. Firstly, for the additional sanctions at an earlier stage discussed above, and which are not regulated in the TFEU, a *reversed qualified majority* stipulation has been introduced through a new Regulation (1173/2011). This means that a Commission proposal on these sanctions will be adopted by the Ecofin Council unless there is a qualified majority against them. Secondly, in the new fiscal compact, the eurozone countries have committed themselves to also support the proposals and recommendations of the Commission in *all* the other steps of the excessive deficit procedure (including the opening of it, as well as the later steps regulated in the TFEU) unless there is a qualified majority against. The implication seems to be that the eurozone signatories of the compact have committed themselves to waive their rights according to the TFEU (which requires a qualified majority *in favour* of the steps mentioned there) and never to vote against Commission proposals and recommendations in the TFEU-regulated parts of the excessive deficit procedure unless there is a qualified majority against. But *legally* they are not prevented from doing so if they would choose to violate the compact: it does not allow for any sanctions in this case and the TFEU would supersede the compact. Hence, it remains to be seen how this provision in the compact will work out.

Another problem that remains is that the decisions in the excessive deficit procedure will be *political* also in the future. It is still the finance ministers in the Ecofin Council who will take them. Although the reversed qualified majority stipulations – if they are followed – make it more difficult to organise blocking coalitions, finance ministers in general may for strategic reasons remain reluctant to punish their peers also in the future. If so, the changed voting rules may not mean that much.

The reforms address the *disconnect* between the European and national decision levels. The introduction of a *European semester* for fiscal policy-making serves this purpose (Regulation 1175/2011). It means that the 'policy cycle' each year will start with the Commission and the Ecofin Council giving member states 'strategic guidance' on policy. This guidance is to be taken into account by member states when formulating their stability programmes. This should be done before key decisions on the national budgets for the succeeding year are taken. This gives the Ecofin Council the possibility to evaluate these programmes with a view to influencing the final national budget decisions.

The fiscal compact goes even further by stipulating that the eurozone countries should introduce into their *national laws*, preferably constitutions, balanced-budget rules (defined as structural, that is cyclically adjusted, deficits of maximum 0.5 percent of GDP under normal circumstances), as well as automatic correction mechanisms including obligations to implement measures to correct deviations from a balanced budget over a defined period of time. The automatic correction mechanism shall be based on common principles to be proposed by the Commission, and which shall also contain guidelines regarding national institutions for monitoring compliance with the balanced-budget rule. The compact gives the signatories the right to bring failures to introduce such rules to the Court of Justice of the European Union, which can order a country to adjust its national budget rule. If a signatory considers that another signatory has not taken the necessary measures to comply with such a judgement by the Court, it may bring the case before it and request the imposition of a fine of maximum 0.1 percent of the member state's GDP.

The establishment of national budget balance rules may seem quite a strict provision. However, a fun-

damental problem is that cyclical adjustments of the fiscal balance can be made in an infinite number of ways. Various estimates of the structural fiscal balance tend to differ substantially and there are often large *ex post* revisions. Since no uniform principles have been established for how the structural balance should be computed – presumably this will be decided by the national governments – there are likely to be large possibilities for manipulating the estimates.

However, it is a clear improvement that common principles regarding the production of the statistics necessary for the EU-level monitoring of actual fiscal balances and government debt have been established. These principles are backed up by the possibility for the Ecofin Council of fining a member state that intentionally or by serious negligence misrepresents deficit and debt data. The fine can amount to 0.2 percent of GDP (Regulation 1173/2011).

The introduction of *broader macroeconomic surveillance* is also a clear improvement (Regulations 1174/2011 and 1176/2011). The aim is to detect macroeconomic imbalances that can later turn into serious fiscal crises while they are still at an early stage. A number of indicators that could signal macroeconomic imbalances are to be monitored: private as well as public debt developments, financial and asset market developments including housing, credit developments, current account developments, and real exchange rate developments. If the Ecofin Council, on the basis of a recommendation from the Commission, judges that imbalances are excessive, it can initiate an *excessive imbalance procedure* (in analogy with the excessive deficit procedure) against a member state, which shall then submit a corrective action plan. If the Council finds the corrective actions insufficient, it can decide that the member state does not comply with its recommendations. This could lead to the imposition of sanctions: firstly an interest-bearing deposit and later fines in the case of repeated non-compliance. These decisions are also to be taken by reversed qualified majority. The maximum deposit and fine is 0.1 percent of GDP. It remains to be seen, however, how easy it will be to take such sanction decisions. Since decisions on excessive imbalances will have a much more judgmental character than decisions on excessive deficits, which are more easily defined, one should expect it to be difficult to use sanctions in the excessive imbalance procedure.

Conclusions

Reforms have strengthened the eurozone's economic governance in several ways. Sanctions can now be imposed much earlier than before. As they have become more graduated, policy makers are likely to be less reluctant to use them, at the same time as the reversed qualified majority stipulation reduces the probability of blocking coalitions in the Ecofin Council. The fact that the proceeds from fines will be assigned to the financial stability mechanisms, instead of being distributed among other EU countries, is likely to increase their legitimacy. The debt criterion in the stability pact has been operationalised and can now trigger sanctions. The connection between EU and national decision levels has been improved through the European semester and the commitment to introduce national budget balance requirements. Common principles, backed up by sanction possibilities, on the production of the statistics required for fiscal monitoring have been established. There will be more emphasis on identifying macroeconomic imbalances that could later create fiscal problems.

At the same time, many of the earlier problems that have undermined the EU rules remain. Sanctions are still pecuniary, which could act as a disincentive to use them, as this will exacerbate deficit problems. Even though the Commission's role is strengthened, the ultimate decisions still rest with the finance ministers in the Ecofin Council, who are also likely to be reluctant to punish their peers in the future. It is not clear how one will resolve the contradiction between the commitments in the fiscal compact to use reversed qualified majority voting in all parts of the excessive deficit procedure and the TFEU, which stipulates ordinary qualified majority voting regarding the steps regulated there. The fact that the balanced budget stipulations in the fiscal compact refer to the structural (cyclically adjusted) fiscal balance could pave the way for biased computations at the national level. Sanctions are unlikely to be used in the new excessive imbalance procedure.

There should be further reforms if one wants to make sure that economic governance is sufficiently strengthened. These could include also *non-pecuniary* sanctions, such as partial or complete loss of voting power in the Council. At a minimum, member states with an excessive deficit should lose their voting right in the excessive deficit procedures against other member states, which would make it even more difficult to stop sanctions. The stipulations on reversed qualified

majority would become stronger if they were incorporated in the TFEU, and did not merely have the character of a commitment in the fiscal compact that could be abandoned, as the Treaty legally supersedes the compact.

A more far-reaching change would be to move decisions in the excessive deficit procedure from the political sphere (the Ecofin Council) to the *judicial sphere* (the Court of Justice), as was suggested by EEAG (2003). The Court of Justice does not currently have the economic expertise to take such decisions, but it could acquire it, for example, by setting up an independent European Fiscal Council with economic experts that could produce background reports for the Court on which it could base its decisions.

It would also be desirable with clearer *rewards* for eurozone countries that reduce their government debts in good times. There is an attempt that goes in this direction in the fiscal compact, which stipulates that where the ratio of the general government debt to gross domestic product at market prices is significantly below 60 percent, and where risks in terms of long-term sustainability of public finances are low, the maximum structural deficit regarded as consistent with a balanced budget can be raised from 0.5 to 1 percent of GDP. One could go further in this direction by gradually increasing the allowed deficit in a step-wise fashion, the lower is government debt, as proposed by Calmfors and Corsetti (2003). Governments that reduce their debt levels would then receive a stamp of approval more visible to voters.

A problem that should be dealt with is the ambiguity in the fiscal compact resulting from the fact that the balanced budget requirement there concerns the structural balance, which can be measured in different ways and is therefore open to manipulation. One way of lowering these risks would be to let the requirement refer instead to a moving average (over a given number of years) of the *actual* fiscal balance. Alternatively, the signatories of the compact could be obliged to set up independent national fiscal councils with the task of evaluating the structural balance as one of their remits, perhaps on the basis of common principles established by the Commission.

A key problem is that the reforms in the EU governance system are made at the same time as the acute crisis management sets precedents for the future. The various rescue packages that have been decided and the establishment of a permanent rescue mechanism, the European Stability Mechanism, as well as the ECB's selective purchases of the eurozone crisis countries' government bonds and its lowering of collateral requirements are all clear violations of the TFEU's no-bail out clause (EEAG 2012). This is bound to weaken the credibility of the governance reforms. If the fundamental no-bail-out clause is not respected, why should one expect the new rules to be observed? And why should fines act as a sufficient deterrent, if a country can borrow to pay these fines and then have someone else pay them in the end?

The hope would be that the high degree of conditionality attached to the current rescue programmes is such a strong deterrent that future governments in the eurozone will do their utmost to avoid ending up in similar situations as Greece, Ireland and Portugal. Arguably, this could reduce the moral-hazard risks from the current bail-outs. However, this argument overlooks the importance of incentives for lenders. To the extent that capital losses are avoided for the investors that have lent recklessly to the crisis countries, their incentives to be more cautious in the future are weakened. For this reason, the agreed restructuring of Greece's government debt is very welcome, as it does impose large losses on private lenders, even if the bail-outs undertaken have gradually reduced their exposure.

From a system point of view, it would be desirable with debt restructurings for Portugal and Ireland as well, since this would make it clear that Greece need not be a unique case. It is unfortunate that European policy makers have argued that Greece is an exception, as it will – to the extent that it is believed – exacerbate the moral-hazard problems.[8] The latter are also likely to be exacerbated by the stipulation that future bail-outs using the new European Stability Mechanism do not necessarily require a consensus among the eurozone countries, as has been the case with the bail-outs from the current European Financial Stability Facility.[9]

How should one judge the chances that the new economic governance system in the EU achieves a reasonable degree of fiscal discipline? It is instructive to

[8] For example, the Statement by the Euro Area Heads of State or Government (2011) says "we clearly reaffirm that the decisions taken on 21 July and 26/27 October concerning Greek debt are unique and exceptional" (European Council 2011).
[9] An *emergency voting procedure* has been agreed, according to which the earlier decided mutual agreement rule is replaced by a qualified majority of 85 percent in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the euro area is threatened (European Council 2011).

compare with the case of Sweden. The country suffered a deep sovereign debt crisis in the early 1990s, which triggered first a successful fiscal consolidation and then led to the adoption of a new fiscal framework. In the last decade, Sweden has on average had fiscal surpluses and consolidated gross government debt fell to as low a level as 37 percent of GDP in 2011. However, the Swedish fiscal framework does not build on rules imposed by the EU, the rules are quite flexible (requiring, for example, a fiscal surplus only over a business cycle), and there are no enforcement or automatic correction mechanisms (EEAG 2012). Instead the system seems to build on a political consensus that Sweden should never again end up in a government debt crisis of the type that occurred in the early 1990s, a high degree of fiscal transparency and a qualified economic policy debate involving monitoring of the government budget by several government agencies with a high degree of independence. Such conditions could be much more important than the new formal rules instituted at the EU level. Without it, there is a great risk that the new EU rules will not acquire the legitimacy among voters that is needed for fundamental changes in fiscal behaviour. If so, the ambitious attempts to strengthen economic governance in the eurozone may turn out to be only a house of cards waiting to fall apart.

The upshot is that what will mainly determine future fiscal performance in the eurozone may be whether there can be a shift in fiscal culture, rather than changes in the formal rules. This would seem to require a number of 'soft' changes to raise the quality of the economic policy debate. This should involve reliable and objective statistics, the use of unbiased macroeconomic forecasts, qualified sensitivity analysis of fiscal policy under alternative assumptions, multi-annual budget frameworks and the establishment of independent national monitoring. The key to responsible fiscal policy would seem to be that deviations from fiscal targets and the emergence of macroeconomic imbalances trigger a national debate at an early stage, imposing high enough reputation costs on governments. A main risk is that, in the reforms of eurozone economic governance, too little attention will be paid to these 'softer' requirements, although they are likely, in the end, to be the decisive ones.

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A Discussion of the Changes to Europe's Macro-fiscal Framework in Response to the Crisis

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Introduction

While only few economists foresaw the economic and financial crisis that started with the problems in the sub-prime mortgage market in the United States, even fewer predicted Europe's sovereign debt crisis. Since the start of Europe's Economic and Monetary Union (EMU) interest rate differentials on euro-area sovereign debt have been very small, and they remained small even after many violations of the Stability and Growth Pact (SGP). However, the debt crisis has shown that financial markets and politicians alike have collectively stuck their heads in the sand. Financial markets thought that public debt was riskless, which turned out to be blatantly wrong, despite the fact that other countries provided bail-out funds to countries in trouble. Politicians treated the SGP as a collective enemy, rather than taking ownership of the constraints that it imposes. While the consequences were manageable as long as the rest of the world economy was in good shape, this was no longer the case after the eruption of the financial crisis in the United States. Weaknesses in Europe's macro-fiscal framework were exposed and extreme turmoil took hold of financial markets. The idea that a collective bail-out would eliminate the unrest was a severe miscalculation. The scale of the crisis was too large, while the underlying sources of the problems cannot be addressed through bail outs. The events have also taught us that budgetary discipline in the public sector is not sufficient to rule out a sovereign debt crisis. For example, while the Irish government followed an austere budgetary policy the country was not immune to the crisis, because its government was forced to bail out its financial sector.

The European Council, the European Parliament and the European Commission have also responded to the crisis with a full package of measures to improve the macro-budgetary governance of the EU. A few years ago it would have been hard to imagine EU governments being prepared to relinquish such a large share of their sovereign powers. It nevertheless remains to be seen whether the measures will be sufficient.

Essentially four sets of measures have been taken. A first set of arrangements was introduced to calm down financial markets. A second set of measures is aimed at avoiding future budgetary crisis, thereby ensuring long-run budgetary discipline in the EU. The third package of measures recognizes the interlinkages between the health of the private sector, and in particular the financial sector, and the public budget, because the government may be forced to bail out private sector institutions during a crisis. Finally, a fourth set of measures is aimed at enhancing the growth potential of European economies through structural economic reforms. In this paper we critically review the various adjustments that have been introduced to the EU macro-fiscal framework. As always, any measures that lack sufficient ownership at the national level are doomed to fail. Hence, the public's and the governments' willingness to adhere to the rules is crucial. Moral hazard remains the Achilles heel of most of the new arrangements. Finally, in some instances Europe's new rules may work out in rather bizarre ways.

The remainder of this paper is as follows. In the second section we summarize the history of events leading up to the current crisis. The third section reviews the measures that have been taken to date, while the fourth section argues that closer budgetary monitoring needs to be introduced, and shown to work, before further steps towards fiscal centralization can be introduced.

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A brief history of events leading up to Europe's debt crisis

Many have been surprised how a relatively manageable problem, Greece's budgetary crisis, could get so out of hand that it threatens the existence of the entire eurozone. In 2004, Greece admitted to having entered the eurozone on the basis of the wrong budgetary figures. About five years later, at an ECOFIN meeting in April 2009, its finance minister refused to clarify the country's financial situation, after which his colleagues asked for further explanation, which they got in July 2009 from Euro commissioner Almunia in a document that foresaw a deficit for that year of around 5 to 6 percent of GDP instead of the 3.7 percent of GDP predicted earlier. The new figure was also based on incomplete data and there were concerns that the eventual figure would be much higher. After its election, the new socialist government led by Papandreou predicted a 12.5 percent deficit in October. The new government's admission ignited a process of slowly increasing unrest in the bond markets that first only affected Greece's public debt, but later spilled over to other countries' public debt. The interest rate on Greece's debt steadily rose, despite repeated announcements of further austerity measures. In May 2010 this culminated in a first 110 billion euro assistance program financed by the European Union and the IMF and to be monitored the European Commission (EC), the ECB and the IMF. Shortly after, as other countries' sovereign debt yields also started to rise dangerously fast, the European Financial Stability Facility (EFSF) was set up with a lending capacity of 440 billion euros guaranteed by the eurozone. This was complemented by a 60 billion direct guarantee from the EU budget through the new European Financial Stabilisation Mechanism (EFSM) and a 250 billion guarantee from the IMF. Financial markets reacted with sudden and sharp declines in borrowing rates and the crisis was perceived as being over. However, the relief was only short lived and interest rates soon started creeping up further. In particular, the 'Deauville Pact' of October 2010, in which Merkel dropped her demand for automatic sanctions for SGP sinners in return for France's support for 'haircuts' on bondholders, generated substantial financial market turmoil. In July 2011 a second 109 billion official rescue package for Greece was agreed. In the meantime, however, Ireland and Portugal had been forced to accept rescue packages. The July 2011 package for Greece foresaw a contribution by the financial sector, as well as an expansion of the powers of the EFSF. In particular, the EFSF would be allowed to finance the recapitalization of financial institutions through loans to governments, also in non-program countries, and it would be able to intervene directly in secondary bond markets on the basis of the analysis by the ECB. However, the initial hope that accompanied the July 2011 package faded fast, as it became clear that a quick ratification was not feasible. This gave way to a hot summer in which Italian and Spanish public debt also came under severe pressure from the financial markets.

Changes in Europe's macro-fiscal arrangements

The failure of EU governments to calm financial markets has led them to introduce substantial adjustments to Europe's macro-economic and budgetary framework. Some changes are intended to deal with crises, while others are aimed at ensuring long-run fiscal sustainability, in the hope of preventing future crises. As far as the latter objective is concerned, a three-pronged or maybe even four-pronged strategy is adopted. Budgetary arrangements are strengthened both at the European level by bolstering their enforcement, and at the national level. Other measures recognize the potential of spill-overs of financial sector imbalances to the public budget. Such spill-overs can be substantial and dangerous, as recent experiences with Spain and Ireland have shown. The last set of measures aims at strengthening the structure of the economies, thereby fostering long-run growth.

Urgency measures in response to the crisis

The European Council of 24–25 March 2011 agreed on the European Stability Mechanism (ESM) as the permanent crisis mechanism to replace the EFSF and the EFSM. The ESM is aimed at safeguarding the financial stability of the eurozone and was originally foreseen to come into force by mid-2013. However, under pressure from the crisis, this date is likely to be brought forward to July 2012, while the EFSF and the ESM will continue to co-exist until the loans made under the EFSF have all expired. The basis for the ESM is an addition to Article 136 of the Treaty on the Functioning of the European Union (TFEU): "the Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality". Financial assistance is supposed to be provided only under a macro-economic

adjustment programme and a thorough analysis of the sustainability of the public debt, conducted by the Commission together with the IMF and in liaison with the ECB. If a macro-economic adjustment programme cannot realistically restore public debt to a sustainable path, the member state concerned needs to negotiate with its creditors to secure their involvement in restoring debt sustainability before financial assistance is granted.

The question remains as to how credible the 'strict conditionality' clause is. As was the case with the SGP, the main weakness of the ESM is that the Ministers of Finance of the eurozone, who form the Board of Governors, take the decisions on whether to grant financial assistance and regarding the terms and conditions of such assistance. This is also where the SGP failed. Politicians find it difficult to deny help to each other and may succumb to public pressure. Knowing that this may happen, moral hazard may easily take hold of countries with a weak discipline culture. This is more than just an 'academic possibility'. The EU has been rife with moral hazard on the side of both borrowers and lenders. Before the current crisis, heavy borrowers may still have been uncertain about receiving a bail-out if they got into financial trouble.[1] Now, a rescue mechanism has been institutionalised and the aforementioned uncertainty about a bail-out has been reduced even further. Hence, it is realistic to assume that the danger of moral hazard has become even more serious than before the crisis. The first signs of this danger have already become visible. Despite agreements on raising tax collection and privatisation of public enterprises in return for financial help, Greece has made hardly any progress in this direction.

Measures to strengthen fiscal discipline

The EU has recently introduced a substantial amount of legislation to strengthen fiscal discipline. Part of the new legislation is contained in the European Commission's 'six-pack', which came into force last December. The six-pack aims at strengthening both the preventive and corrective arm of the SGP. Within the preventive arm it imposes a cap on annual expenditure growth linked to the medium growth of the economy and it introduces the possibility of sanctions, which take the form of an interest-bearing deposit. In the corrective arm it introduces the possibility of opening the Excessive Deficit Procedure (EDP) on the basis of the debt criterion. Sanctions will now be imposed *via* 'reverse qualified majority voting'. That is, the Commission recommendation for a sanction will be accepted, unless a qualified majority of the countries votes against it. This change makes it harder for countries to escape sanctions, although the Finance Ministers can still block them. No doubt there will be pressure on them to do so, especially when a large country is lined up for sanctions. The proof of the pudding will be in the eating and, hence, it remains to be seen whether ECOFIN is really prepared to impose sanctions on future fiscal sinners.

The 'fiscal compact', which was recently concluded at the European Summit of 30 January 2012 and has now been signed by 25 EU member states, complements the six-pack. The compact envisages enshrining the European fiscal framework in national law, preferably in the constitution. Doing so would hopefully enhance the credibility of the common fiscal framework. In particular, the compact requires countries to include a limit on their annual structural deficit of 0.5 percent of GDP. It also envisages an automatic correction mechanism in the case of a deviation from the rule. Finally, the compact sets a convergence path for the public debt to its reference level in case it exceeds 60 percent of GDP. While the compact seems to represent a significant step forward in stimulating discipline, the Bundesbank President criticised it (Financial Times Deutschland, 2 February 2012) by saying that: "the guidelines for the national fiscal rules leave considerable room of *manoeuvre* and there is no control on a European level to check if they are really respected". Indeed, the compact does not specify what should happen if the country fails to stay below the structural deficit limit, nor does it specify the precise form of the correction mechanism when a deviation occurs. Presumably, this is left to the choice of the country concerned. Furthermore, imposing a rule on an object that is not directly observable, the structural deficit, may leave some room for countries to wriggle out of the necessary adjustment needed to comply with the rule.

The six-pack also imposes minimum requirements on national budgetary frameworks intended to cover all levels of government. The requirements take the form of a Directive that governments have to implement in national legislation. EU member states have to install numerical fiscal rules to promote compliance with the reference values for public deficits and debt. They also need to establish medium-term budgetary frameworks

[1] Although financial markets hardly discriminated against such borrowers, probably believing that the no-bail-out clause would somehow be circumvented if necessary.

(MTBFs) that allow for a fiscal planning horizon of at least three years. Multi-annual objectives for general government deficit and debt consistent with the numerical fiscal rules and projections of major spending and revenue items of the general government based on unchanged policies should be included in the MTBFs. The MTBF forms the basis for the preparation of the annual budget.

Table 1

Average errors

	Nowcast minus plan (1)	Ex post minus nowcast (2)	Ex post minus plan (3)
BAL	– 0.17* (0.10)	– 0.34*** (0.11)	– 0.50*** (0.17)
REV	0.02 (0.12)	– 0.60*** (0.18)	– 0.59*** (0.21)
EXP	0.19 (0.12)	– 0.26 (0.16)	– 0.09 (0.18)

Notes: The average errors are all expressed in percent of GDP with standard errors (corrected for heteroskedasticity and serial correlation) reported underneath. Further, * = significance at the 10% level; ** = significance at the 5% level; *** = significance at the 1% level. Abbreviations: *BAL* = Budget balance/GDP; *REV* = Revenue/GDP and *EXP* = Expenditure/GDP. The sample period is 1999-2008 for columns (1) and (3) and 1998-2008 for column (2).

Source: Beetsma *et al.* (2011).

There is a rather substantial body of literature on the effectiveness of self-imposed fiscal rules, and particularly on the balanced-budget rules that virtually all states in the United States have imposed upon themselves. While US fiscal arrangements differ in many respects from Europe's, experience with the sub-national rules in the United States may be instructive for a proper design of fiscal arrangements at the national level in Europe. The performance of the state-level rules differs widely across the US states. Rules are more likely to be binding if they are enshrined in the constitution than in secondary legislation. In their now classic paper, Bohn and Inman (1996) conclude that for self-imposed rules to be effective, they should be enforced by an independent supreme court capable of imposing serious penalties. The national legal status of the numerical rules and MTBFs may differ across countries, yet the Directive does not specify details about monitoring and enforcement of the rules. Hence, there is a danger that these national arrangements will ultimately have less bite than anticipated.

Properly designed national fiscal arrangements can be an effective way of enforcing fiscal discipline. The reason for this is that the countries themselves are responsible for the design and adoption of their own arrangements and, hence, are likely to feel more responsibility for meeting the requirements imposed by these arrangements than for complying with restrictions 'imposed by Europe'. Indeed, several authors have shown that well-designed national budgetary arrangements are conducive to fiscal discipline. Debrun *et al.* (2008) explore the effects of national fiscal rules on fiscal policymaking. They construct a fiscal rule index that increases in its strength and coverage. The strength of a rule is larger if the legal base of the rule is stronger, the body in charge of monitoring and enforcement is more independent, the enforcement mechanism is stronger and media visibility is higher. Coverage refers to the share of the general government balance covered. The authors show that a higher value of the fiscal rules index is associated with a lower cyclically-adjusted primary deficit.

Well-designed national fiscal institutions may also lead to more reliable fiscal figures, which, in turn, would be conducive to avoiding turbulence in sovereign bond markets. Table 1, which is extracted from Beetsma *et al.* (2011), reports the average deviations of the budget balance, revenues and expenditures in percent of GDP for 14 EU members over the period 1998–2008 or 1999–2008 in the (1) the 'nowcast', i.e. the current-year forecast for year t made at the end of year t, from the plan for year t made at the end of year $t-1$, (2) the eventual *'ex-post'* figure for year t from the nowcast, and (3) the eventual figure from the plan. All data are taken from the Stability and Convergence Programs that countries have to submit to the European Commission. Clearly, planned budget balances are overly optimistic on average in terms of the nowcast figures, which, in turn, tend to be overly optimistic in terms of the *ex-post* figures. Relative to these *ex-post* figures, planned balances fall short by 0.5 percent of GDP on average. While the over optimism of the planning stage relative to the nowcast stage is driven by spending being higher than planned, over optimism at the nowcast stage is driven by an exaggeration of the eventual revenue figures.

Beetsma *et al.* (2009) and Beetsma *et al.* (2011) explore the sources of the over optimism at the planning and the nowcast stage. However, better national fiscal institutions, whether measured through a higher fiscal rule index (defined as in Debrun *et al.,* 2008), a higher MTBF index or a higher transparency index,[2] reduce the optimism bias at both the planning and the nowcast stage. Hence, better fiscal institutions seem to be conducive to making real-time fiscal figures more reliable. In a detailed study of the Netherlands, Beetsma *et al.* (2010) explore what suitable budgeting institutions at the national level might look like. While not perfect, the so-called regime of 'trend-based budgeting' since 1994 has worked quite well for the Netherlands. This regime was characterised by expenditure ceilings, cautious budgeting and a strict separation between the expenditure and revenue side of the budget, restricting the use of revenue windfalls for extra expenditure. Unfortunately, the practice of using cautious growth projections was abandoned during the last Balkenende cabinet.

Ruling out (excessive) macro-economic imbalances

The debt crisis has shown that fiscal constraints alone are not enough to rule out budget deficits. Imbalances in the private sector, such as large debts on the part of households or firms, may lead to instability in the banking sector if outside circumstances or market sentiments change. To prevent a systemic crisis, the government may be forced into a bail-out of a troubled bank. This happened in the case of Ireland, which had a relatively low public debt ratio until the start of the current crisis. However, through the forced bail-out of the Anglo-Irish Bank and support to other banks, Ireland saw its public debt ratio in 2010 shoot up by almost 35 percent to around 100 percent. As a result, Ireland became the first country to receive support from the EFSF and the EFSM.

Recognizing the link between private sector developments and the public budget, the six-pack also contains a regulation to prevent imbalances, as well as a regulation to enforce a reduction of excessive imbalances once they have arisen. Imbalances indicate macro-economic developments with the potential to adversely affect the country concerned or its EU partner countries. The first regulation provides the basis for an early warning system, which consists of an alert system with a scoreboard based on a set of macro-economic and macro-financial indicators. The early warning system envisages preventive action before imbalances become too large. The second regulation referred to as the Excessive Imbalances Procedure (EIP) allows for enforcement through the potential use of financial sanctions.

Obviously, this part of the six-pack can only be an imperfect answer to the emergence of (excessive) imbalances. The aforementioned indicators cannot perfectly determine whether imbalances exist nor whether they are harmful. For example, a substantial current account deficit may be justified if the country under consideration is relatively undeveloped, but has good growth prospects. More importantly, large current account surpluses may also be deemed harmful and require correction. However, it is crucial to consider the source of such surpluses. If they arise because the country has acquired a competitive edge through clever structural policies, a good educational system and wage restraint, then this can hardly be blamed on the country. Forcing countries to give up those policies would go against the principle of following best practices. If we think of Northern Europe as running current account surpluses and Southern Europe as running current account deficits, it is in any case very doubtful that punishing the former group would solve the imbalances problem (see also Gradus and Beetsma 2012). One reason is that both blocks also trade with other countries within the EU and outside the EU. More importantly, it denies the fact that the source of Southern Europe's current account deficits is its lack of competitiveness (partly) due to poorly-functioning labour and product markets. A first-best policy would be to exert enforcement on countries for following the wrong policies leading to imbalances. Here, one should not only think of reforms of labor and product markets, but also of regulation and supervision of the financial sector as long as this remains a national competence. In addition, a more activating welfare system will reduce public spending and is conducive to labor force participation.

Structural reforms imposed at the EU-level

Structural reforms are necessary to unleash Southern Europe's growth potential. This will also make it easier to achieve fiscal sustainability. To bolster the member states' economic structures, the EU countries

[2] An MTBF in Beetsma *et al.* (2009) and Beetsma *et al.* (2011) is defined as an institutional device to extend the horizon for fiscal policymaking beyond the annual budgetary calendar. The index measures the institutional strength of the framework and is increasing in the connectedness between the multi-annual targets and the annual budgets, the involvement of the parliament, the existence of a coordination mechanism and the degree of monitoring and enforcement. The 'six-pack' also requires member states to publish information on contingent liabilities with large impacts on the public budgets.

agreed on the so-called ‘Euro Plus Pact’ at the European Council of 24 and 25 March 2011. Among other things the pact specifically requires member states to undertake all measures that are necessary to foster competitiveness and employment. The former will be assessed on the basis of wage and productivity developments. The needs for adjustment will be explored with particular attention to wage setting arrangements, the degree of centralization in bargaining and wage indexation mechanisms. The latter is assessed on long-term and youth unemployment and labour participation rates, which is arguably the country’s most important statistic in this regard. Unfortunately, the Euro Plus Pact lacks an enforcement mechanism, even though the consequences of a lack of reform may spill across borders if countries need to make use of the EU’s financial rescue mechanisms.

How to proceed?

To ensure the long-run existence of Europe’s common currency some form of further fiscal centralization is unavoidable. The current arrangements have proven to be unworkable. In particular, they have proven to be a recipe for moral hazard, while the greatest sinners in budgetary terms have failed to take responsibility for their policies, thereby undermining the functioning of the common currency. However, fiscal centralisation means different things to different people.

One view is that it calls for the introduction of Eurobonds (‘stability bonds’ in European Commission language) or the enlargement of Europe’s emergency funds. As far as stability bonds are concerned, the Commission (2011) has issued a green paper in which it sets out the rationale and conditions for issuing such bonds. Issuance would be pooled across member states and, in its most far-reaching form countries, would share in the revenue flows and debt-servicing costs.

The Commission mentions a number of advantages of stability bonds. In particular, financial market pressure on the countries currently in trouble would be alleviated, while risks of sudden liquidity dry-ups would be reduced. Risks to the banking system would also be reduced because the value of those bonds would fluctuate less than that of individual country sovereign debts and because the home bias in sovereign debt holdings would be reduced (lowering the exposure of banks to domestic assets). Liquidity premiums would fall and the transmission of monetary policy would be facilitated through the creation of a larger pool of safe and liquid assets. Finally, the larger issuance volumes and higher liquidity of the secondary markets would strengthen the position of the euro as an international reserve currency.

The main drawback of stability bonds, in particular under the assumption of joint and several guarantees, as is also recognized by the Commission, is that they may stimulate moral hazard. The effects of fiscal profligacy at the national level on the common debt yield will be diluted, providing a disincentive to austerity in all countries in the system. Hence, the Commission argues that the introduction of stability bonds would need to be accompanied by reinforced fiscal surveillance and policy coordination. Such coordination must also extend to avoiding and correcting harmful macroeconomic imbalances due to their potential spill-overs to the public finances. However, experience suggests that it will not be easy to avoid additional moral hazard through intensified monitoring. Given that countries that currently pay a low interest rate on their public debt might experience a disadvantage from the introduction of stability bonds, the Commission suggests redistributing some of the net benefit from high-yield countries to low-yield countries. This would also reduce moral hazard according to the Commission. To us it is unclear, however, how such a redistribution of the benefits from stability bonds could ameliorate the problem of moral hazard. Moreover, it creates scope for a largely political discussion about redistribution, which creates new inefficiencies and moral hazard problems too.

In our view, fiscal centralisation should *start* with much closer monitoring by EU institutions, and particularly by the European Commission, of the budgeting processes in the eurozone member states. If the process threatens to derail, the EU should have the option of intervening or taking over the budgeting process. This type of fiscal centralisation will be needed to internalize the growing spill-over effects of fiscal decisions at the national level. In effect, these spillovers create a ‘soft budget constraint’ at the national level, because the consequences in terms of financial market turbulence of a debt default in a member state are too severe for the ECB and the rest of the EU not to come to the rescue of the state under financial threat. Fiscal centralisation through closer monitoring of budgeting would need to be accompanied by more centralised supervision of the financial sector. The latter is needed to avoid regulatory capture and

the associated excessive risk taking leading to harmful cross-border spill-overs.

Only *once* the hurdle of tighter budgetary monitoring has been taken and shown to work properly for a number of years, does it make sense to consider further centralisation through the introduction of Eurobonds, or an enlargement of Europe's emergency funds. The run-up to the current crisis can teach valuable lessons in this regard that tend to be too easily forgotten during the crisis itself. Further fiscal centralization requires a sincere and strong commitment to fiscal discipline. If countries are unwilling to relinquish some of their sovereign powers to pave the way for tighter fiscal monitoring, one must question their commitment to discipline.

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Coordination of Fiscal Policies: A Necessary Step toward a Fiscal Union

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The post-2007 economic crisis has illustrated the advantages and limitations of an active fiscal policy. The current difficulties in the euro area point to the failures of European governance, including the fiscal framework of the Stability and Growth Pact (SGP). The necessity of a fiscal rule is a consensus among economists. The first aim of the rule is to ensure credible and sustainable control of public finances. The second aim is to facilitate the relationship between governments and the Central Bank. The SGP is based on the existence of a public spending bias; deficits are not reduced in good times because governments tend to use fiscal policy in an exaggerated manner, making it difficult to achieve a balanced budget. The aim of the SGP is also to reduce negative externalities. A country in a monetary union may be tempted to use large deficits because the crowding-out effect is diluted in the euro area. The current context clearly indicates a failure of the Pact in these main objectives. Some European countries have taken advantage of good economic periods to finance fresh expenditure, rather than to consolidate their fiscal positions (Hauptmeier *et al.* 2011). The case of Greece demonstrates the existence of free-riding behaviour. Moreover, the political will to implement the excessive deficit procedure has failed, leading to the repeal of several procedures (France and Germany in 2003, Greece in 2007). The new reforms of the Pact tend to increase fiscal discipline and improve enforcement mechanisms. Balanced budgets and debt objectives are given more importance by requiring larger adjustments when ceilings are exceeded. The sanction process has been accelerated because the European Council can only prevent sanctions proposed by the Commission if a qualified majority votes against these sanctions. However, the principle of automatic sanctions has not been successful, which limits the effectiveness of the new pact.

The occurrence of a global crisis demonstrated the need for fiscal action at the European level, rather than only at the national level. Several studies support the case for a fiscal union in the euro area. There are various proposals for the design of this fiscal union: (i) an interregional fiscal transfer mechanism as insurance against asymmetric shocks (Dullien and Schwarzer 2005), (ii) an increase in the European budget to establish a horizontal fiscal equalization mechanism (Italianer and Vanheukelen 1993; Hammond and von Hagen 1998), and (iii) the introduction of Eurobonds backed by all member countries (De Grauwe and Moesen 2010; Favero and Missale 2011).

Although the propositions presented above are relevant, they face a major political deadlock. Therefore, European fiscal integration must be conducted following another path. Using the typology of Fuest (2011), we propose a further 'supervision and coordination' approach, focusing on the aspect of coordination. According to this approach, European governance is based on strong fiscal rules and the effective coordination of decentralized fiscal policies. This approach allows a trade-off between commitments based on a system of rules and the need for flexibility to respond to various economic shocks. The use of effective fiscal coordination is institutionally justified because it is compatible with the EU operational framework, it is theoretically justified because it implies higher welfare, and it is economically justified because it takes into account macroeconomic heterogeneities. The coordination of fiscal policies in a monetary union is multifaceted: it encompasses several situations and reactions. The implementation of effective coordination may lead to institutional change through the establishment of a permanent fiscal council.

The paper is organized as follows: the first section presents justifications for the use of fiscal coordination. The second section proposes a new analytical framework for coordination, and the third section discusses the role of a fiscal council. The final section offers some conclusions.

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Why should fiscal policies be effectively coordinated?

Coordination and welfare gains

The literature on this subject has shown the importance of coordinating fiscal policies. Some authors suggest that coordination is not useful because the SGP should be sufficient. Effective coordination implies discretionary behaviours that may be costly; these behaviours may be time consuming, cause time lags in decision making and implementation, and dilute national responsibility (Issing 2000). From this perspective, coordination does not necessarily enhance welfare in a monetary union (Beetsma and Bovenberg 1998; Beetsma *et al.* 2001; Dixit and Lambertini 2003).

In contrast, several studies have confirmed the advantage of effective coordination when governments consider externalities of other countries' actions (Engwerda *et al.* 2002; Uhlig 2003). Coordination is more advantageous when the scope is ambitious and coordination is not limited to surveillance of national policies (Ferré 2008). Fiscal coordination appears to be compatible with the SGP and may even enhance stabilization gains (Schalck 2006). Finally, it should be noted that gains from coordination are more important when governments internalize the objective of monetary policy and in the case of a conservative central banker (Cavallari and Di Gioacchino 2005; Acoccella *et al.* 2007).

Macroeconomic heterogeneities

Although the academic debate is not clear cut, a crucial, yet under used, advantage of fiscal coordination is the existence of macroeconomic heterogeneities, which reflect differences in economic structures and differences in macroeconomic key variables (GDP, prices, costs, international trade). In a heterogeneous monetary union, fiscal convergence through a fiscal rule can lead to a suboptimal situation involving measures that are partially or completely unsuited to the national situation, which may increase negative externalities, rather than reduce them. Conversely, effective coordination considers these differences and allows adjusted responses.

We can distinguish several macroeconomic heterogeneities; we will focus on three to support our argument. The first heterogeneity is the structure and the effect of national fiscal policies. Due to the subsidiarity principle, countries use fiscal policy for internal purposes that correspond to preferences for social protection and the provision of public goods. Hence, there are differences in fiscal variable reactions to economic cycles (Bouthevillain *et al.* 2001) and in fiscal multiplier values (Favero *et al.* 2011).

The second heterogeneity concerns the monetary policy. The ECB established monetary policy for the euro area as a whole based on an analysis of the average situation. However, the effects of monetary policy are asymmetric across countries (Angeloni *et al.* 2003; Affinito and Farabullini 2009), which can lead to unsuitable policies that are too restrictive for some countries and too lenient for others. The asymmetric effects can be explained by the characteristics of borrowers (including risk aversion, disposable income, and alternative funding sources) and the characteristics of banking systems (including concentration and balance sheet structure).

The third heterogeneity includes all national differences because it consists of the divergence of economic growth. We can easily see the persistence of non-synchronized business cycles, or 'rotating slumps', which weaken European economies through wage-price and real interest rate dynamics (Landmann 2011). Without a fiscal stabilization mechanism to limit the size of the national cyclical fluctuations, the euro area would be characterized by macroeconomic instability.

A new framework for fiscal coordination

Coordination of fiscal policies is often presented as a stabilization tool for supply or demand shocks through the minimization of a joint loss function by all governments. This view is restrictive because coordination can take many forms appropriate for different situations. Therefore, we propose a new framework based on two criteria: the origin of the shock relative to the monetary union (internal or external) and the shock's propagation (individual or common). The breakdown by the origin of the shock reflects differences in the action capability (room for the manoeuvre's amplitude, efficiency measures, role of institutions). The breakdown by propagation corresponds to a requirement of the viability of a monetary union because we must consider several economies. The combination of these two criteria leads to four possible situations in terms of coordination (Table 1).

Table 1

Types of coordination

	Individual shock	Common shock
External shock	Support	Effective coordination
Internal shock	Supervision	Cooperation

The support case corresponds to the reaction to an individual external shock. The aim is to limit the propagation of a negative shock within the monetary union or, conversely, to share a positive shock with other countries. For example, the support could manage speculative attacks on government bonds that lead to non-justified financial difficulties. This coordination could consist of temporary discretionary measures (guarantees, loans, and incentives to trade).

The supervision case corresponds to the reaction to an individual internal shock. It reflects the monitoring of fiscal policies to avoid pro-cyclical policies. The objective is to limit negative externalities and free riding. Greece's statistical revisions on the public deficit and the increase in public expenditure in good times are examples of supervision implementation. Supervision can be conducted through fiscal rules. From this perspective, the rule is seen as a passive approach to coordination.

Effective coordination is a reaction to an external common shock. The aim is to provide a comprehensive and coherent response to achieve greater stabilization, thereby preventing national differences that induce significant tensions within the monetary union and undermine its viability. The establishment of the European recovery plan in 2008 is a good example of overall effective coordination. Conversely, the lack of cooperative behaviour may lead to the development of sub-groups of countries that are in similar situations, but have different needs (e.g. GIPS versus core countries). The European leaders' difficulties in coming to an agreement on the case of Greece demonstrate the dangers of a monetary union without a coordination mechanism.

The last case is cooperation, which is the reaction to an internal common shock. In such cases, aggressive competition among states to promote their economies is less profitable because the situation is a zero-sum game: gains made by the competition may be reduced by externalities from the economic degradation of other economies. Cooperation is a way to limit the adverse effects associated with fiscal competition.

The role of a European fiscal council

The coordination of fiscal policies as presented above does not require an institutional change; coordination can be accomplished within the European Council with the assistance of the Commission. However, coordination is more effective if it is conducted by a permanent fiscal council. The fiscal council is often presented in literature on this topic as an enforcement tool for fiscal rules or an independent fiscal watchdog (Calmfors 2010). This role can be extended. The appropriate response to a shock may evolve over time, implying a transition from one type of coordination to another. This transition may be costly in terms of delays in decision making and action. The fiscal council may significantly reduce these costs through forecasting exercises, as well as *via* the evaluation of *ex ante* and *ex post* fiscal measures. The question that remains is the selection of its members.

Conclusion

The recent economic and financial crisis has demonstrated the weakness of current European governance and revived the debate on the fiscal union. Given the operational framework and preferences of policy makers, this union should initially be made through fiscal policy coordination. This mechanism would take into account national differences and increase welfare in the euro area. This paper shows that there are several forms of coordination that contribute to a flexible stabilization mechanism, which is more effective if it is connected to a European fiscal council. National governments must delegate more responsibility at the European level, an idea which they have found difficult to accept to date. This nevertheless constitutes a logical and desirable approach to economic and political integration in a monetary union.

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European Fiscal Union: From Monetary Back Door to Parliamentary Main Entrance

Waltraud Schelkle*

An 'unprecedented divorce' between monetary and fiscal authorities

A European fiscal union is suddenly no longer the wild dream of diehard EU federalists or the nightmare scenario of Eurosceptics, but a reality that takes shape through the back door of monetary crisis management. This article argues that the crypto-union, created involuntarily by the ECB, has prevented a second financial collapse and is the paradoxical consequence of trying to prevent a European fiscal union. But I also conclude that, indeed, an effective and legitimate solution requires this fiscal union to become part of the democratic process in member states.

A modern monetary system is characterized by fiat money, issued by a central bank that exercises its interest rate policy with a view to the state of the economy, not the state of the ruler's finances. Modern money is a public good for a collective, and not the private property of government. This requires some separation of monetary and fiscal authority so that the general public can trust that the legal tender is not debased and devalued for reasons of political opportunism. How much central bank independence this separation requires is a matter of political-constitutional preferences and differs across time and between places.

The economic constitution of EMU is based on a historically 'unprecedented divorce between the main monetary and fiscal authorities' (Goodhart 1998). Unlike a broken marriage, this was not seen as failure but as a great achievement of EMU, obviously more like ending an illegitimate relationship in many member states. Divorce was meant to depoliticize monetary policy completely and thus ensure price stability even against intense popular pressure for stimulus. The financial instability in European bond markets since 2009–10 has renewed doubts about the wisdom of this construct that some macroeconomists had raised before (e.g. Buiter *et al.* 1993; Eichengreen and Wyplosz 1998).

Confronted with the prospect of another systemic collapse, the ECB could hardly resist buying Treasury (and other) bonds from banks to keep them afloat (see also De Grauwe 2011). This Securities Market Programme (SMP) has given way to a massive recapitalisation programme of the European banking system since the launch of the Long-Term Refinancing Operation (LTRO) in December 2011. This recapitalisation has been tackled only half-heartedly by the fiscal authorities in member states and is long overdue. However, the quasi-fiscal activities of the ECB keep up appearances of separation at best. The Bank can thus claim to fulfil the mandate of any central bank, namely maintaining the stability of the financial system. Moreover, by operating only in secondary markets and through the banking system the Bank supposedly avoids moral hazard for profligate governments; but the policy creates moral hazard for the financial industry instead. The crisis has thus revealed that the separation, far from strengthening the central bank through splendid isolation, creates a paradoxical weakness. The ECB is drawn into bailing out sovereign debtors and insolvent banks precisely because EMU lacks fiscal backing for a joint monetary policy, unlike the central banks in the United States or Britain (Buiter 2009).

The next section shows how this paradox manifests itself in this crisis. One may therefore ask why complete divorce was untenable[1] and how some form of fiscal union could set monetary policy free again to do what it does most effectively, which is smoothing business cycles, rather than dealing with solvency

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[1] There are, of course, critics like Jens Weidmann (2012), Head of the Bundesbank, who maintain that the principle of complete divorce should have been upheld. However, these principled critics have so far failed to explain what they would do if confronted with another Lehman or Northern Rock 'moment', i.e. the threat of another systemic financial crisis.

problems of sovereign or private debtors. A degree of joint public debt management can provide the minimal fiscal union required to stabilise the monetary union, as a number of authors have suggested (Giovannini group 2000; De Grauwe and Moesen 2009; Delpa and von Weizsäcker 2010). The third section argues for a variant that is meant for policy coordination in normal times to get the policy mix with monetary policy right (Mabbett and Schelkle 2010). It also argues that the political authority for any form of Eurobond must come from democratically elected parliaments. The new European Semester, which has brought national parliaments into the EU process of fiscal surveillance since January 2011, could lend political authority to this new stabilising institution and make the involvement of parliaments more meaningful at the same time. This is outlined before the concluding section.

Fiscal union through the monetary back door

The ECB and the European System of Central Banks (ESCB) have become quasi-fiscal agents during the second phase of the crisis that started in 2007–08. This seems to confirm all the warnings that Eurosceptics had expressed before the onset of EMU. However, their scenarios missed the point. It was not collusion between the central bank and governments that created this heterodox role for the proudly independent institution in Frankfurt. Rather, the unforeseen feedback loop between bank balance sheets and government finances 'fiscalized' the monetary policy of the ECB in at least two ways. It was ultimately the concern for the stability of the banking system that created a fiscal union through the back door of monetary policy.

The financial-fiscal feedback loop, not a weak and broken Stability Pact, has proven to be the Achilles heel for independent monetary policy. If it were government finances as such that mattered, Belgian bonds should have been sold more heavily and Spain should not be in the spotlight, while Germany with its debt ratio of over 80 percent would not issue the benchmark bond. Under the Basel II regulations, Treasury bonds from OECD countries were classified as safe assets and they arguably were safe, with a few exceptions, Greek bonds being one of them. The Great Recession in the wake of the financial crisis wrecked government finances and worsened debt ratios through negative growth. When bond markets then started to discriminate between sovereign debtors, the bank balance sheets of those (European) banks and pension funds holding Greek, Irish and Portuguese bonds deteriorated rapidly.

In short, policymakers felt that they could not let even small sovereign debtors default, but urged these governments to take pro-cyclical austerity measures instead. In return for austerity, the ECB reluctantly provided refinancing for Treasury bonds of junk status. This has created a knife-edge equilibrium in which sovereign debtors pretend to be solvent and European banks pretend to be liquid. Thanks to the self-fulfilling nature of this feedback loop, many may very well be solvent and liquid respectively; but all depends on the lifeline thrown by central banks and on growth resuming eventually.

How can we recognize the 'fiscalization' of monetary policy when we see it, and the creation of a crypto-fiscal union through central banks? In his insightful discussion of quantitative easing, Blinder (2010) gives us several examples that shed light on the ECB through the lens of the US experience. Generally, Blinder (2010, 476) considers all those monetary policies to be 'quasi-fiscal' policies that "put taxpayer money at risk [..] equivalent to investing government funds in risky assets". This definition makes the implicit assumption that there are, one the one hand, monetary policies that deal with liquidity problems and are as such riskless for the taxpayer and, on the other, 'quasi-fiscal' monetary policies dealing with solvency problems, which ultimately fall on the taxpayer. This is a powerful fiction that allows the separation of macro-prudential and micro-prudential supervision. However, this distinction between liquidity and solvency issues vanishes in a crisis (Goodhart 1987). The market dynamic, as well as the handling of a systemic liquidity crisis, can push institutions into insolvency that were healthy if risky before. They fall prey to rising risk premia and penalty discount rates. Blinder's general definition is therefore a useful reminder of just how fictitious the complete divorce of monetary and fiscal policy is.[2]

Secondly and more specifically, Blinder (2010, 468) characterizes those operations as "the first breaching, however minor, of the wall between fiscal and monetary policy" whereby fiscal policy tried to engineer a stimulus programme through the Fed. The Treasury

[2] For instance, Belke and Dreger (2011) give a rough estimate of taxpayers' risk in the four big euro area countries from a restructuring of Greek debt, part of which is held by the ECB.

engaged in excess borrowing and deposited the excess funds at the Fed; the latter could then, without increasing bank reserves, expand its balance sheet on the asset side. In his definition of quasi-fiscal operations Blinder also includes the Fed's outright purchase of debt from Fannie Mae and Freddie Mac, the wholesale refinancing institutions for the mortgage market. This purchase was a measure to stop the free-fall of mortgage and housing markets and put taxpayers' money at risk.

Does the Securities Market Programme (SMP) qualify as a quasi-fiscal operation in this sense of investing public funds into risky assets? It was created in May 2010 and had, as of 17 February 2012, accumulated a volume of 219 billion euros. Under this programme, the ECB buys government bonds in secondary markets only while private bonds can be bought in primary and secondary markets.[3] This is in line with the Treaty, which does not allow the ECB to buy Treasury bonds from sovereign debtors directly. The preamble states in paragraph (4) that the Governing Council decides on the scope of the interventions and will do so in light of the commitments by member states to meet their fiscal targets and pursue fiscal consolidation. Intervening in secondary markets only, while not announcing a target bond yield, means that the ECB lets market forces decide what interest rates sovereign borrowers have to pay at each auction. Sterilization ensures at the same time that there is no money creation directly from the ECB's outright purchase of securities, i.e. the Bank does not increase its balance sheet, but reduces its lending to banks to that extent.[4] The SMP therefore resembles the Fed's purchase of bad debt from Fannie Mae and Freddie Mac, but without the stimulus from an extended balance sheet.

Another quasi-fiscal activity concerns the recapitalisation of banks through monetary policies on the liabilities side. Instead of capital injections from government funds that have been authorised by parliament, the central bank can help financial institutions to earn a margin that would allow them to restore their balance sheets out of their current income.[5] The central bank thus takes over the fiscal role in a solvency crisis. The long maturities and a negative real interest rate guaranteed by the ECB in the most recent vintage of Long-Term Refinancing Operations (LTRO) can be seen in this light.

Until July 2010, refinancing facilities for between 12 and 36 months stood at over 500 billion euros, then dropped sharply and were nil for this maturity class by January 2011. Under Mario Draghi, the LTRO were racked up by a staggering 489 billion euros in December 2011, disbursed as a fixed rate tender over three years at one percent interest. Another half trillion euros was offered at the time of writing at the end of February 2012. This meets European banks' enormous needs for refinancing in nervous markets (IMF 2012). However, the refinancing needs of governments are more than double that over the next two years, yet the SMP has been scaled back noticeably ever since the LTRO in December 2011 was launched. This change of tack means that the ECB now guarantees banks a sizeable margin over three years that they can use to recapitalise their fragile balance sheets and meet higher capital requirements. The European Banking Authority had urged banks to build up their capital base in a well-timed recommendation issued on 8 December 2011. The underlying hope may also be that banks should thus be able to absorb the losses that will occur if the ECB no longer acts as lender of last resort to sovereign debtors. However, in contrast to a government programme of recapitalisation, banks cannot be forced to forego the pay-out of large bonuses as long as there is a need for recapitalisation.

In sum, the monetary union crisis can be said to have led to a crypto-fiscal union, through central bank interventions that perform quasi-fiscal functions. In contrast to expectations, it is not directly the political pressure of governments that made the ECB assume these functions, but the stability of integrated financial, including bond, markets. The present move under the new President Draghi bears witness to this in that the Bank has tried to tackle the problem of financial stability more directly through a 'big bazooka' LTRO, while winding down the SMP. The SMP has pushed the Bank into a defensive position whenever private sector involvement, i.e. partial default of a sovereign debtor, has been on the table. The irony in all this is that the ECB would have been less susceptible to assuming this role if it had more fiscal backing from member states, contrary to what critics like Bundesbank President Weidmann (2012) say.

[3] See the decision of the ECB establishing a securities markets programme (ECB/2010/5).
[4] See URL: http://www.ecb.int/mopo/liq/html/index.en.html#portfolios.
[5] Blinder (2010) talks about this indirectly when he criticizes purchases of Treasury bonds as actually unhelpful in this respect, as they flatten the yield curve. The steeper this curve, the easier it is for financial institutions to restore their balance sheets out of earnings from the margin between short-term borrowing and long-term lending.

Existing and proposed varieties of Eurobonds

The idea of a Eurobond has been discussed for a while now, in fact the Giovannini report contemplated it as early as 2000. The innovation would be the joint liability for the issue, in addition to the individual liability of each member state for its share. The outright rejection of a Eurobond by some governments, such as those of Germany and the Netherlands, may lead an observer to believe that such joint liability would be a radical innovation. However, the European system of central banks is already built on this principle. The capital of the ECB is held solely by (all EU) national central banks included in the Eurosystem. National central banks have to pay any net losses that the ECB incurs, for example, in the pursuit of the lender of last resort function (Art. 33, s.2 and Art.29, s.1 ESCB Statute). That is, national taxpayers in all (!) EU member states would have to pay in proportion to the paid-up capital share of their central bank. In turn, if national central banks bail out domestic financial institutions that have significant business in other member states, the ECB can compensate such a central bank for the losses incurred out of its surplus from seignorage (Art. 32, s.4, ESCB Statute). Joint and several liability is thus inherent in the insurance pool that the common ownership of the ECB entails. The profits or losses of the ECB and national central banks are the tangible expression of this fiscal risk sharing through the monetary back door.

However, if one does not want to leave these decisions to un-elected policy-makers for good reason, then this fiscal union should be constructed in a more transparent way. The new emergency facilities, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), have no joint guarantee from the member states, each one is only liable for their own share in it. This has several disadvantages. Not only are the EFSF and the ESM finite funds in contrast to open-ended commitments of the tax and transfer states behind them. Any such finite fund tends to be tested and is bound to run out in a messy crisis. Moreover, whenever one of the guarantors gets itself into trouble or has its credit rating downgraded, the whole edifice becomes shaky. The recent downgrade of the EFSF was a faint warning of how fragile this construct is.

Knowing that fund solutions are not solutions, but temporary stop-gaps at best,[6] far-sighted scholars have proposed variants of Eurobonds that are deliberately designed as risk-sharing arrangements, rather than as ill-conceived attempts at containing liability.

- The short, non-technical report of the Giovannini group (2000) considers four options of integrated public debt issuance, but only two of the options involve joint liability. One is to have a Community institution, like the European Financial Stability Mechanism (EFSM), that borrows and then lends on to member states. The joint liability stems from the guarantee by the EU budget. This communiterization has recently been granted to the tune of 60 billion euros and can hardly be extended further when ten of the 27 EU countries backing the budget are not euro area members. The other option is indeed 'creation of a single euro-area debt instrument backed by joint guarantees'. The report is rather luke-warm and sees a number of technical and legal difficulties with the creation of such a joint liability when size and maturities are very different. However, the group, largely made up of financial investors, also lacked the expertise and the mandate to discuss the wider political and macroeconomic implications of this.
- De Grauwe and Moesen (2009) proposed a Eurobond to give countries like Greece guaranteed access to funding, albeit at the national market interest rate. Compliance with the fiscal framework would not be a condition of access. Instead, each country would pay its market rate, which would penalise the profligate (assuming they were accurately identified by the markets) and address German resistance to a common interest rate for countries that had breached the SGP. At the same time, the bond issue would be guaranteed by all the subscribing countries, and the coupon that bondholders receive would be calculated as the average of the market interest rates that the participating countries paid. This seemed to be an ingenious way to combat the 'flight to safety' and enlist market forces to discipline countries at the same time through the adjustment of bond prices.
- Delpa and von Weizsäcker (2010) propose a variant of the Eurobond that would deal with the stock problem of overindebtedness, rather than the flow problem of liquidity. The bond issue of every member country would be divided into a blue bond part of up to 60 percent of a country's GDP and a red bond part for the rest of its outstanding debt.

[6] As Kindleberger (2000) concluded long ago with regard to the IMF as a solution to the instability of the Bretton Woods system in its dying days.

> The blue bonds enjoy the joint guarantee of euro area members while the red bonds constitute purely national debt with junior status to which orderly default procedures apply. This two-tier Eurobond could thus be used to organise a radical solution to Europe's public debt problems. The proposal addresses a number of legal and practical problems and is clearly geared to alleviate what is policymakers' worst headache at the moment.

The two most detailed proposals have a lot going for them. They are politically realistic in that they do not try to give the Commission a role that member states and their electorates are not prepared to delegate at the moment. The De Grauwe and Moesen scheme, however, sees the Eurobond primarily as a vehicle to provide emergency liquidity, and does little to rein in the pro-cyclical behaviour that pushes countries into deeper recession or unsustainable booms while it also gives governments little incentive to treat national budgets as a matter of common concern. The Delpa and von Weizsäcker scheme, by contrast, gives incentives for countries to comply with the stipulation of a 60 percent deficit ratio; but its stated purpose of engineering an orderly debt default does not bode well for the political and market acceptance of the Eurobond idea.

Fiscal union through the parliamentary main entrance

An alternative proposal builds on these predecessors, but envisages the Eurobond as a vehicle for policy coordination in normal times. It has always been a weakness of the euro area's policy framework that the aggregate fiscal stance cannot be steered, for lack of a federal budget. Even if governments would have been able and willing to comply with the Stability Pact, it would have asked them to treat fiscal policy as a matter of national concern for consolidation rather than a matter of common concern for counter-cyclical stabilisation. The idea is as follows (Mabbett and Schelkle 2010): member states would have to agree annually – or more frequently if economic circumstances so require – on the overall volume of Eurobonds to be issued and the share of each member state. This would determine, within reasonable margins of error, the appropriate fiscal stance for EMU as a whole, based on the projected cyclical phase for the euro area. By determining the quota and thus the contribution of each country to the overall stance, the facility could take account of the fact that we still have asynchronous business and asset market cycles in the monetary union. The Eurobond issue would be guaranteed collectively by the member states, and all would pay the same interest rate. In contrast to De Grauwe and Moesen (2009), this Eurobond should not have any country names attached to it.

Access to the Eurobond would be granted only if a government complies with this European fiscal framework. There would be no guarantee that it can use up to 60 percent of its GDP, or in fact have to stay within any such arbitrary number. Eurobond conditions would send a signal to markets that could raise spreads for countries that had used up their access rights, so that borrowing to finance an excessive deficit might begin systematically to carry an interest rate penalty. Governments would still be able borrow outside this framework, comparable to the Red Bond in Delpa and von Weizsäcker (2010), and excessive deficit countries might still be able to borrow cheaply in good times. However, member states who do this may find their share in the Eurobond allocation reduced in the next period, in other words the variable national quotas can be used to sanction those who do not stay within the agreement. The Eurobond would thus make a start in giving EMU's fiscal framework some pecuniary substance, but also positive incentives for compliance.

Our proposal should be more acceptable politically as it is forward looking, introduced with respect to new bond issues, and not a vehicle to solve inherited public debt problems. This must be left to the ECB and the ESM over the next two decades. A retroactive introduction of joint liability would amount to overriding a national parliament's right to sanction the budget beforehand, as elected representatives of taxpayers. The involvement of national parliaments is an indispensable element of such a joint debt instrument in a European monetary union of democracies. In this sense, a fiscal union cannot be disentangled from a political union.

The European Semester provides an opportunity for such involvement. This process has brought national parliaments into the cycle of the EU's surveillance, rather than coordination, of national fiscal and reform policies. Based on National Reform Programmes (October 2010), the Commission drafted an Annual Growth Survey (January 2011) based on which the policy priorities were agreed in the Council (in March). Governments then sent their budgetary plans for scrutiny to the Commission (in April), which gave country-specific guidance on these plans (by

June/July) before national parliaments discussed and passed budgets in the autumn. The experience of the first cycle indicates, unsurprisingly, that it was a top-down process of one-way communication to which national actors tend to respond by ignoring it. The European Parliament passed a resolution in December 2011, noting in particular the tight deadlines that left national parliaments little room to respond or be involved when corrective action was requested (European Parliament 2011: paragraph 57). This is also a major criticism in an extensive evaluation of the European Semester by the Green Party Group in the European Parliament (Derruine and Tiedemann 2011).

The incentives to engage in the process would increase for both sides, if the content of the *ex ante* coordination would be the setting of an envelope for the budget balance that can be financed through Eurobonds. The EU institutions, Council and Commission, would then have a vital interest in signing up national elected representatives to the EU agenda, rather than merely lecturing them about prudent policy (hypocritically so in the case of the Council). National parliaments, in turn, would more clearly see the rewards of staying within an EU policy framework. They could still take responsibility for budgetary actions that are not agreed within this framework, but cannot expect any insurance or solidarity from the EU if they do so. The Eurobond would give tangible expression to the fact that the monetary union has created a community of risk, but also a club good of an insurance mechanism from which everybody can benefit, but to which everybody must also contribute.

Conclusion

In this article, I argued that the crisis has led to a paradox of fiscal union through monetary policy. This is a paradox because fiscal policy was deliberately left non-unionised so as to safeguard the independence of the ECB. I identified the Long-term Refinancing Operations at a fixed rate over three years to be a channel of a fiscal union through the back door, in addition to the usual suspect of the Securities Market Programme.

In contrast to many critics of this ‘abuse’ of monetary policy, I argued that it was the idea that monetary and fiscal policy can and should be completely separated that has led to this paradox. It was not government debt as such, but the feedback loop between bank balance sheets and government finances that left the ECB little choice but to intervene in this way, to stabilize the financial system in line with the mandate of any central bank. There was no fiscal actor who could take responsibility.

If one wants to relieve the ECB from its quasi-fiscal role, a minimum form of fiscal union is necessary. To this effect, a version of a Eurobond that serves macroeconomic policy coordination for the purpose of stabilisation (Mabbett and Schelkle 2010) was previously outlined. The issue of a Eurobond must be combined with the new policy process of a European Semester in order to be democratically viable and effective. The experience with the first round of the European Semester suggests that national parliaments have still little incentive to engage with EU fiscal surveillance and to consider their decisions as a matter of common concern, and understandably so as long as fiscal surveillance is a top down, one-way process with no positive rewards. In turn, the EU process must acknowledge that monetary union has created, more by default than by design, a risk pool and an insurance mechanism; this requires political endorsement from the representatives of those that ultimately pay for it.

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Should Europe Become a Fiscal Union?

Christian Keuschnigg*

Introduction

The European unification process started with the creation of a common market area to allow member countries to benefit from the economic gains of free trade and factor movements in Europe (Keuschnigg and Kohler 1996). A key turning point was the adoption of a single currency to complete the economic unification process by eliminating exchange rate risks within the euro area, creating more liquid and integrated capital markets, and guaranteeing price stability at the European level (Sapir 2011). The current financial and fiscal crisis puts these achievements at risk, has revealed a political conflict over how to deal with the crisis and how to reform the institutions, and may even endanger the continued existence of the euro area. It is important to remember that the economic and monetary unification process was driven by the economic as well as political goals of establishing not only prosperity, but lasting peace in Europe. These fundamental political objectives, however, are not automatically guaranteed by deeper economic integration. Institutions must be reformed in a way that economic integration itself doesn't become a source of new and dangerous political conflict.

Should Europe opt for a fiscal union? The answer requires a consensus on whether Europe should move towards a closer political union and develop into a federal state with substantial fiscal capacity at the central government level. It also depends on whether one expects the creation of a fiscal union to be instrumental in solving the current economic crisis in Europe. The following section analyzes the emergence of the economic and fiscal imbalances that led to the current crisis (see also Keuschnigg 2012). The third section discusses the case for a fiscal union and argues that establishing a fiscal union will not address the key problems that have led to the current crisis. The final section offers some conclusions.

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Economic and fiscal imbalances

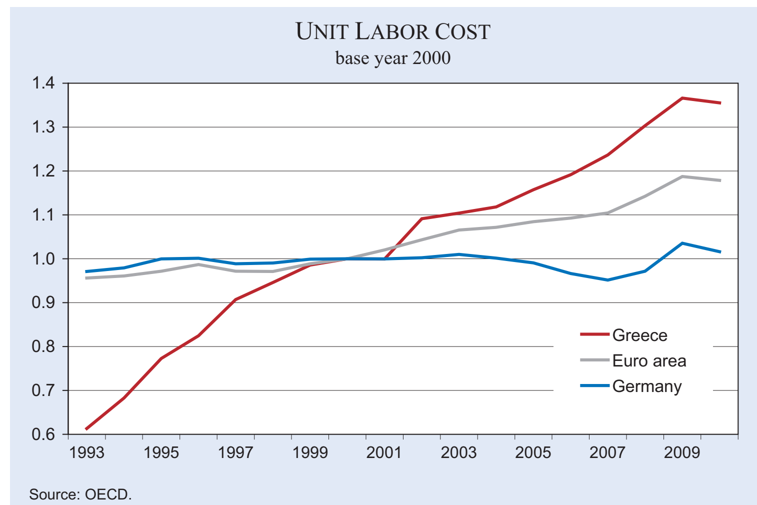
Prior to monetary unification, the guiding principle of European unification was the notion of subsidiarity. The subsidiarity principle implies that the power to levy taxes, to spend on public goods and services, and to regulate the behavior of the private sector should be decentralized whenever possible, and remain in the realm of autonomous sovereign countries (CEPR 1994). The introduction of the common currency was a decision to give up independent national monetary policy and to transfer responsibility for price stability to the European Central Bank (ECB). It also eliminated a country's independent exchange rate as a key relative price that could adjust to avoid large trade imbalances and unsustainable international borrowing as a result of divergent wage and productivity growth rates. The smooth operation of a common currency area requires that independent exchange rates are replaced by other adjustment mechanisms. Economic theory lists four such mechanisms (see e.g. De Grauwe 2009; Beetsma and Giuliodori 2010): (i) wage flexibility to realign unit labor costs with international competitiveness; (ii) labor mobility across regions; (iii) central fiscal institutions to provide insurance against asymmetric shocks; and (iv) strict fiscal rules to prevent negative spillovers of national fiscal policy to other member countries.

Divergent competitiveness

Up to very recently, none of the four conditions for an optimal currency area seems to have been fulfilled. Few member countries have reformed *labor market institutions* to allow sufficient wage flexibility that could compensate for the exchange rate as an adjustment mechanism. Due to cultural and language barriers, *labor mobility* across countries tends to be low in Europe and is certainly not happening to an extent that could significantly reduce major differences in unemployment and labor market conditions more generally. There is no central layer of government

with a budget that could provide fiscal insurance against asymmetric shocks and thereby dampen regional economic fluctuations. If a US state experiences an income loss of one dollar, about 40 cents are compensated by *fiscal insurance* as that region pays fewer taxes to the central government, but collects more transfers from unemployment insurance and other social programs. The European Union budget is far too small to achieve any similar automatic stabilization. Finally, the *fiscal rules* of the Maastricht treaty, which are meant to limit deficits to 3 percent and debt levels to 60 percent of GDP, have not been credible and have been plainly ineffective in preventing the current sovereign debt crisis in Europe. One must conclude that the consistent violation of those principles led to the current crisis (see, among others, Buiter and Rahbari 2001; Feldstein 2011; Roubini 2011; Sinn and Wollmershäuser 2011).

Figure 1



Source: OECD.

I believe that the single most important problem is the divergent trend of unit labor costs in Europe, as illustrated in Figure 1. Eventually, this persistent divergence must cause large trade imbalances, leading to accumulation of net foreign debt by weak countries in the southern periphery and net foreign claims by other, more competitive countries such as Germany. These divergent trends have not been corrected by an exchange rate nor a wage adjustment for a long time. For an uncompetitive economy, this implies the need for either an external or an internal devaluation, in both cases making a country's exports cheaper in world markets and imports more expensive, allowing the country to settle on a sustainable path of income growth consistent with national productivity. While Germany went through a prolonged period of wage moderation and painful labor market reform (Hartz reforms), Greece, Portugal, Spain and Italy (Ireland) have increasingly fallen behind. Rigid labor markets and nominal wage stickiness have prevented the requisite adjustment in these economies.

The wage costs per unit of output increase with higher wage rates and decline with productivity gains. When wages increase in line with productivity growth, unit wage costs stay constant. The rising unit wage costs in southern periphery countries are partly induced by a capital market failure. Figure 2 shows that interest rate differentials in the euro area relative to Germany largely disappeared after the introduction of the euro, eliminating risk premia and inducing a real estate and investment boom in the South. The inflow of capital and low capital costs might have facilitated wage increases not backed by long-lasting productivity gains. When interest rate differentials appeared again in the last two years, a large part of these investments were probably no longer profitable with increased capital costs. The failure of capital markets to price in risk premia and the resulting allocation of capital towards uncompetitive economies is probably itself the consequence of a lack of credible fiscal rules and represents regulatory failure in Europe.

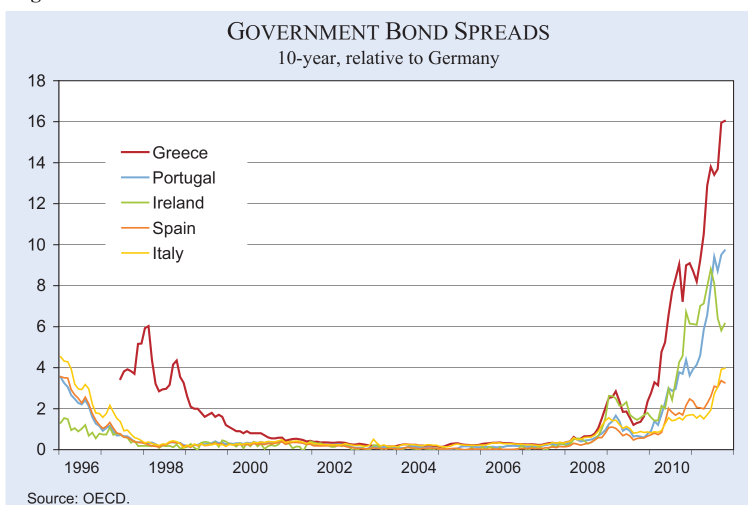
The Maastricht criteria were not effectively imposed and lacked credibility right from the beginning. Capital markets also seemed to conclude that the no-bailout rule would not hold up in a crisis since bankruptcy of a highly indebted member country would be perceived by the Union to be even more costly (this way, high debt creates a negative externality on other countries). Given this belief, banks and other investors must have expected to always get their money back, making government debt an apparently very safe investment. Under these circumstances, there was no need to include a risk premium, which would have increased interest costs in southern countries in the EU and could have helped to impose market discipline and to restrain the tendency towards excessive debt financing.

The second regulatory failure that probably contributed to the current debt crisis is that equity capital

standards for European banks were, and still are, too low which creates systemic risk. The weak capitalization of banks makes them vulnerable to economic shocks and raises the probability of bank failures. Given the inter-linkages and mutual lending in the banking sector, failure of one bank threatens the survival of others (a negative externality) and forces the latter to cut back lending to the private sector, which may trigger a sharp recession, or even a systemic crisis if other banks were to be pushed into bankruptcy too. Since a country conceivably cannot risk such a hugely costly course of events, it will always have to bail out distressed banks. If (systemically important) banks can expect an implicit state guarantee, they have easy access to cheap and apparently safe funds, which creates strong incentives to engage in risky lending and other risky investments. Such a strategy generates very high profits in good times, while large losses in bad times can be covered up by the tax payer (a negative externality). The implicit guarantee to the banking sector thus facilitates aggressive lending to risky countries and businesses and probably has made a significant to excessive lending to the private sector and governments in the southern European periphery. Higher minimum equity ratios of banks are essential to internalize the social costs of risky bank lending. They would make banks more hesitant to engage in risky lending, and more careful to evaluate credit risk and correctly assess the required risk premium. Higher equity standards thereby become a precondition for imposing market discipline on excessive deficit financing by financially weak governments and firms. They make banks more able to withstand negative shocks and reduce systemic risks. In making them safer, higher equity ratios should also reduce banks' costs of refinancing on the capital market and should not contribute to higher credit costs to the private sector on average. They only eliminate those risky investments that are no longer profitable when the risk of failure is correctly reflected in the interest cost. Such investments, however, should not have been financed in the first place.

To sum up, the key problem to be addressed is the divergent competitiveness of European economies, resulting in balance of payment problems and large imbalances in international lending and borrowing. The euro is too strong for the less productive countries in the South and too weak for highly productive countries such as Germany. Even in the absence of fiscal debt, increasing net foreign debt of uncompetitive economies arises when the private sector overborrows compared to its capacity to generate wage income and profits. Clearly, if both the exchange rate and domestic wages do not adjust, the missing price mechanism leads to accumulating foreign debt, independent of public sector deficits. In part, the euro may actually create and exacerbate fiscal imbalances. Since the euro is too strong for low productivity economies, structural unemployment becomes very high and profits remain persistently low, making firms very vulnerable to adverse shocks. Unemployment inflates social spending and reduces wage tax revenue, low profits further reduce tax revenue and lead to high rates of business failure, which may cause further fiscal demands on the public sector to recapitalize banks or important private sector firms. The developments in Spain and Ireland, where fiscal debt was not excessively high prior to the crisis, seem to be in line with these arguments. Clearly, low growth and recessions are not conducive to healthy government finances.

Figure 2



Negative externalities

Negative spillovers affecting other member countries arise if a country accumulates unsustainable fiscal and private sector debt, and could occur in several ways, including (i) fiscal bailouts or sovereign default, (ii) contagion *via* financial markets, and (iii) inflation and/or high interest rates. The first and most obvious negative externality arises if other member countries are more or less forced to bail out an illiquid country to prevent the nega-

tive consequences of uncontrolled sovereign default. Large transfers and a redistribution of resources may be required to prevent default. If default occurs, wealth is lost in other countries since, in an integrated capital market, national debt is held by investors or banks in the entire union.

This leads to the second externality, i.e. contagion of other countries *via* financial markets. Anticipating the risk of default, investors demand a risk premium on newly issued debt, and the value of outstanding debt declines to reflect the higher yield due to increased risk. The devaluation of fiscal debt, triggered by unsustainable fiscal policies, destroys large amounts of wealth in other countries, be it with banks, insurance companies, pension funds and private investors. If banks are weakly capitalized, as is a main problem in Europe, other member countries may ultimately be forced to invest substantial public funds to recapitalize systemically important banks or to protect other investors, at the taxpayers' cost. In the worst case, when these countries themselves become increasingly exposed to fiscal risk, investors and rating agencies will have to reassess their sovereign risk as well, leading to higher costs of government financing.

Finally, depending on the nature of common monetary policy, the tendency for debt financing may affect other countries in terms of higher inflation or higher interest rates. The inflation tax devalues the real value of savings and financial wealth, as well as that of private and public debt in all member countries, and thereby redistributes in an uncontrolled way from savers towards debtors. To prevent inflation, the ECB is committed to price stability and is not allowed to engage in government debt financing. Alternatively, given a non-accommodating monetary policy, excessive debt may contribute to a higher interest rate in a common capital market, thereby restricting investment and growth in the entire union.

An externality distorts economic behavior. From the perspective of the entire union, the presence of negative externalities arising from high fiscal debt means that individual member countries do not fully internalize all economic costs and might rely excessively on deficit financing. Moral hazard implies that member countries will not be able to fully exploit the gains from European unification. To realize the full gains, moral hazard must be contained and external costs must be effectively internalized. This can be achieved by market forces, fiscal rules and banking regulation. In a well functioning capital market, interest rates should include a risk premium that accounts for sovereign default risk. The prospect of rising interest costs imposes market discipline on individual member countries and helps to restrain deficit financing. The institutional solution, as enshrined in the Maastricht Treaty, implements fiscal rules that restrict the admissible deficit and debt levels, and punishes countries for exceeding these thresholds. Higher equity standards and tighter regulation of banks can significantly reduce the risk of contagion through a weakly capitalized banking sector.

Coordination failures

The sovereign risk premium serves a key purpose, namely to impose market discipline on government debt financing. It reflects investors' perception of a country's bankruptcy risk, the risk of not getting back a large part of one's money in case of a haircut, as in Greece. Banks and investors, possibly supported by the analysis of rating agencies, must judge a country's ability to service and pay back debt in full when it is due. The risk premium is a forward looking concept that reflects a country's future fiscal capacity. It depends on the strength of tax revenues, which itself is a function of a country's growth potential. It reflects unfunded pension obligations that entitle workers to pension benefits in exchange for contributions and are a promise no more or less than the promise given to investors to pay back government debt with interest. The risk premium also reflects other expenditure risk like the need to recapitalize banks under adverse economic conditions, or the need to fulfill the guarantees that are given to fend off the fiscal crises and sovereign bankruptcy in other countries. Finally, and very importantly, the risk premium reflects the perceived interest rate risk of a highly indebted country.

The risk premium thus reflects the investors' forecast of future fiscal capacity and risk of sovereign default. Obviously, it depends on informed judgments and expectations. In case of highly indebted countries, these expectations often depend on volatile investor sentiment and can realistically turn into self-fulfilling prophesies. Suppose a highly indebted country has accumulated debt in the expectation of historically low interest rates on safe government debt of, say 3 percent, and suppose the budget is balanced to keep debt from growing further. At this rate, the share of interest spending in total expenditure is reasonably manageable. If a recession comes or another unforeseen expenditure shock arrives, the budget runs into deficit and the country may experi-

ence a liquidity problem. If investors become more pessimistic, they might start to anticipate problems with the country's solvency and upwardly revise the country's risk premium. As debt is rolled over and an increasingly larger share must be refinanced at high interest rates (say 6 percent), more and more of the budget must be reserved for interest payments, leading to a further deterioration in the country's fiscal position and an even larger risk of default. As interest rates rise even more (see Figure 2) and expenditure for debt service explodes, the country maybe effectively be pushed into default. The key point is that a highly indebted country with a liquidity problem would still be solvent and could pay back debt at normal interest rates of 3 percent, but is insolvent and must default when interest rates rise to levels of 10 percent and more. Expectations are self-fulfilling. When investors are optimistic and believe in solvency, they expect to get their money back and can do at a safe interest rate of 3 percent. At that kind of interest rate, the country is solvent. When investors are pessimistic, they expect to lose their money with a high probability and can lend only at a very high interest rate to compensate for the risk of default. At the higher rate, the country is insolvent and must default. Volatile expectations can cause large welfare losses as market expectations 'coordinate' on a bad equilibrium (see e.g. De Grauwe 2011).

Sovereign risk premia are important to impose market discipline on governments. It is equally important that they are not driven by volatile expectations on the part of nervous investors, which may end up in excessive interest costs for countries that face a liquidity problem, but are still solvent at normal interest rates. There are arguably three ways to prevent coordination on a bad equilibrium with sovereign default, which all involve some form of limited guarantee. The first and crudest way is to require the *ECB* to give an implicit guarantee by purchasing government debt to stabilize the market and prevent interest rates from rising above a maximum level. In keeping interest rates low, it helps highly indebted countries to stay solvent, but does nothing to improve incentives for responsible fiscal behavior, and may even lead countries to relax and further postpone consolidation efforts. It is criticized as being incompatible with the ECB's task of price stability and not financing government debt. The second is the creation of *Eurobonds* that are jointly guaranteed by euro area member countries and would be rated as very safe. In their crudest form, they would be available to all euro area countries at the same interest rate, which would be higher for fiscally strong and lower for weak countries, thereby redistributing from strong to weak countries. More refined versions such as Muellbauer (2011) would essentially combine this with administered risk premia, set by an independent Union agency, where revenues could also be used to compensate tax payers in strong countries to compensate for extending the guarantee to weak countries. This would reward fiscally responsible behavior and make excessive debt financing more expensive. The responsibility to push through structural reform to strengthen the fiscal capacity would remain with the commission or other institutions. The third way to address a bad equilibrium with distressed countries risking default are *public lending institutions* such as the European Financial Stability Facility (EFSF) and its follow up institution, the European Stabilization Mechanism (ESM), and the International Monetary Fund (IMF).

When a country is shut off the capital market, it may obtain 'conditional' lending *via* the ESM (in the following, ESM also refers to EFSF as well) in collaboration with IMF and the European Commission. A member country can get lending from the ESM only if it accepts strict surveillance and implements a tight restructuring program to restore competitiveness, growth and fiscal solvency (Gros and Mayer 2010, suggested a 'European Monetary Fund'). Since *conditional* ESM lending implies a considerable loss of national sovereignty, a country applies only if financing on the capital market is no longer possible at acceptable interest rates. The ability to impose a painful restructuring program makes ESM lending different from other sources of funds, and allows for the refinancing of distressed countries even when normal banks cannot lend any more. The conditionality is also the key difference to the ECB buying government bonds to stabilize markets. In this case, the responsibility to push through painful adjustments to restore growth and fiscal sustainability rests with other institutions. The key advantage of ESM lending is that refinancing cannot happen without an adjustment program, i.e. refinancing and structural reform are tightly connected and surveyed by the same institution. In this respect, the creation of a powerful ESM fund valuably complements existing institutions to support convergence, such as fiscal rules, coordination and surveillance of economic policy, and the limited investments by the commission's structural funds. If these institutions fail to prevent divergent competitiveness in Europe, a tight restructuring and adjustment program under ESM lending may force such adjustment *ex post.*

The key question remains whether the ESM is endowed with enough financial capacity and guarantees from the member states to be able to handle a speculative attack on government bonds by large member countries such as Italy and Spain. If this happens, very fast policy action and large amounts of financial resources are required. Under normal conditions, the ESM should be able to refinance itself on the capital market at low rates, reflecting a triple A rating thanks to the paid in capital and additional guarantees of the euro area member states. The credibility of this arrangement seems to be doubtful as large member states have already been downgraded recently. In the event of a sudden systemic crisis, the ESM might not be able to raise enough funds in short order to support large countries. One option would be to endow the ESM with a banking license, allowing the required refinancing with the ECB. Such refinancing could be limited to well specified and exceptional conditions, and would not be possible under a more normal course of events. Even if such refinancing occurs, it would not be possible unconditionally, but could only happen when the country subjects itself to an ESM program for tight structural adjustment.

A fiscal union for Europe?

Should Europe become a federal fiscal union with a central government with own taxes and a substantial fiscal budget? One can approach this question from at least three perspectives. Firstly, independent of the current crisis, one may discuss the economic arguments in favor of centralization or decentralization of different functions of government in a federal state, and how many and which countries should be members of the union. Secondly, there are important arguments beyond narrow economic considerations in favor of or against a closer political union such as establishing peace in Europe or enhancing Europe's influence in world politics. And thirdly, one can ask whether moving towards a fiscal union is a way out of the current crisis and can provide the required conditions for the smooth operation of the economic and monetary union.

In a federal state, some important advantages speak in favor of centralization (see Oates 1999 or CEPR 1994 on vertical assignment of government functions; Bordo *et al.* 2011 and Henning and Kessler 2012, for an account of US history). When there are important spillovers from local government activity, centralization can improve policy outcomes by internalizing spillovers. Most evidently, public goods with community wide benefits should be centralized to exploit economies of scale. If labor mobility is very high, redistribution and income protection might be more effective at the central level. The argument is that the tax benefit system attracts welfare recipients and alienates tax payers, which puts fiscal pressure on individual governments and might lead to a 'race to the bottom'.[1] Centralization also facilitates decision making and policy coordination, especially when a large number of national decision makers with diverse interests have to come to an agreement, or if the joint benefit of common policies yields different distributional results across regions. Policy coordination and spillovers call for centralization of macroeconomic stabilization. If macroeconomic fluctuations are statistically independent or at least imperfectly correlated across regions, the community can stand to gain significantly from insurance against asymmetric shocks.

There are important arguments in favor of decentralization. Local governments are closer to citizens and are thus democratically more accountable. They tend to be better informed about local affairs so that decentralized policies are much better aligned with local economic conditions and preferences. Decentralization also leads to more experimentation in policy making and favors political innovation, which may be imitated by other regions. The experience of more innovative governments provides valuable insights into the effectiveness of new policies and sets benchmarks for good policy-making. Decentralization leads to fiscal competition that might not be seen as a race to the bottom, but rather as a welcome discipline for the excessive growth of government that might arise from adverse incentives in the political process. The EU once adopted the principle of subsidiary which, by default, argues in favor of decentralization. Member states should be fully sovereign over fiscal policy. Fiscal rules such as the Maastricht Treaty or the new fiscal compact will prevent negative spillovers to other countries. While fiscal policy remains under national sovereignty, member countries have ceded considerable regulatory power to establish common goods markets and protect the free movement of capital and labor in Europe.

A key question is whether a fiscal union could make Europe more of a common currency area, provide

[1] Labor mobility is certainly much higher within homogeneous member states, but is traditionally low across culturally diverse European countries. Hence, the argument seems to favor centralization of redistribution at the national, but not at the union level.

effective automatic stabilization of the economy, and help to prevent a repetition of the current crisis.[2] To discuss this matter, it is useful to distinguish between the concepts of a fiscal union and a transfer union. A *transfer union* leads to systematic and long-lasting income transfers and redistribution across different regions such as in Germany after unification, which are both presumably intended to narrow down the differences in income and welfare levels. Such transfers currently occur in limited amounts in terms of EU spending on structural funds, which provide co-financing of national infrastructure and other investments to make economically backward regions more competitive. How much they contribute to effective economic convergence is subject to debate. Large and persistent transfers, especially for consumptive purposes, may create substantial political tensions and frictions among culturally heterogeneous regions. Donor countries resent the fiscal cost of net contributions, while net recipients resent the conditions and foreign influence that usually comes with such transfers. Even within more homogeneous nation states, interregional redistribution as part of fiscal equalization schemes is often hotly disputed and sometimes creates political forces for separation (the Italian North-South divide, Belgium, or the separation of Czechia and Slovakia). There are serious doubts as to whether a large scale transfer union could be politically sustained in Europe.

A *fiscal union,* in contrast, is set up to provide fiscal insurance to smooth income fluctuations over time and across regions. Insurance means that transfers are transitory and unsystematic. Suppose that unemployment insurance were to be centralized with uniform benefit rules and contribution rates in all member countries such that the central budget would be balanced as long as unemployment rates do not deviate from trend levels. When the economy moves into recession, the system runs into deficits that are reversed in subsequent boom periods. Such an insurance system would smooth income fluctuations *over time* and provide important automatic stabilization, provided that the insurance system is endowed with an effective debt brake. There must be an automatic increase in contribution rates or a tightening of benefit rules to repay debt incurred after a recession. Unemployment insurance at the European level could also smooth income fluctuations *across regions.* When Germany is in a boom and France experiences a recession, the average unemployment rate may just be ‘normal’. The system then sends a net transfer from Germany to France without there being a deficit or surplus in the central budget. Contributions exceed benefits in Germany, but the surplus just offsets the deficit in France. If the economic situation is subsequently reversed, the net transfer flows into the other direction. This way, a fiscal union can dampen regional fluctuations and automatically stabilize the economy without there being a systematic and sustained transfer across countries.

The precondition for a fiscal union is that unemployment risk is independent and fluctuations are uncorrelated across regions and over time. If countries have structurally different unemployment rates, the system will again lead to systematic cross-subsidization and redistribution, as is the case in any system that provides uniform insurance of good and bad risks. Systematic cross-subsidization within an insurance system may be politically as unacceptable as open income transfers and redistribution across countries with very different cultures. Even worse, when the fiscal union degenerates into a transfer union, it contributes to moral hazard and may slow down the reform effort. Cross-subsidization implies that the cost of high unemployment is partly paid by others and diminishes a country’s incentive to actively fight structural unemployment by forcing greater wage flexibility and implementing other painful labor market reform. To avoid this, contribution rates and benefit rules would have to be adjusted to account for country specific unemployment risk. The system would need to specify a much less attractive tax benefit ratio for Spain, Greece, Italy and also France while the package could be more attractive for Austria, Netherlands and Germany.

The key problem in a currency union is that exchange rate adjustments must be replaced by wage adjustment to offset different productivity growth and divergent international competitiveness. While a fiscal union may be able to insure part of the unsystematic fluctuations across regions, it will not help to eliminate sustained income and employment differentials, and may, in fact, even aggravate the problem by reducing incentives for implementing painful labor market reform. It does nothing to offset the tendency towards balance of payment imbalances and the accumulation of foreign debt on the part of weak and uncompeti-

[2] Marzinotto *et al.* (2011) suggest the creation of an EU finance ministry to supervise fiscal policy and assess liquidity and insolvency of member countries. It would have veto rights over national budgets and a taxing capacity of maybe 2 percent of GDP to be activated in the event of crisis. They also recommend tighter regulation and supervision of financial institutions and the creation of a euro area deposit insurance system for banks.

tive countries. Expanding the scale of structural fund spending and concentrating it more on weak countries could, in principle, help the latter catch up and become more competitive. If not complemented by wage moderation, countries such as Greece tend to find it difficult to fully absorb structural funds and translate them into productivity-increasing investments. Experience to date with structural funding has been rather mixed and it takes far too long to have a significant impact.

If a fiscal union is excluded and automatic stabilization cannot happen *via* a central budget, there must be sufficient flexibility at the national level. To dampen short-run fluctuations, automatic stabilizers must be effective *somewhere*, at the central or de-central level. Effectively limiting deficits to 0.5 percent of GDP permanently as part of the new fiscal compact may be too strict. If deficits are not allowed to fluctuate enough, member countries might end up with sharper recessions. In my view, fiscal rules in Europe should achieve two conceptually different tasks. Firstly, they must ensure a reduction of fiscal debt over a prolonged period to a low target level of 60 percent or less, a level that is realistically safe to keep risk-premia and interest costs low. However, debt ratios should not be reduced to zero if deficits are strictly and permanently limited to 0.5 percent of GDP, as this would amount in many countries to a huge program of intergenerational redistribution. Secondly, they must guarantee an effective debt brake that allows debt to GDP ratios to fluctuate at around this target level so that fiscal systems can be effective automatic stabilizers. However, as a legacy of past fiscal irresponsibility, the stabilization function is probably impaired in the first adjustment period. To bring down debt ratios in the union, the bias towards deficits must be turned into a bias towards surpluses, allowing for deficits only in very exceptional circumstances and in limited amounts.

Conclusions

Moving towards a fiscal union does not address the fundamental problems of divergence in Europe. Given the large cultural heterogeneity and diverse preferences over the size and scope of government activities, fiscal policy should remain in the realm of national sovereignty, while important regulatory power is assigned to the European Commission. Although several different scenarios seem possible, I believe that current institutional developments and further reform will result in a better functioning of the euro currency area. Key developments are: (i) more credible fiscal rules to prevent negative spillovers to other member countries, combined with tighter fiscal and economic surveillance; (ii) more market discipline by a better capitalized and more prudent banking sector with sovereign risk-premia differentiated according to fiscal stance and economic competitiveness; (iii) ESM lending to member countries with liquidity problems subject to strict conditionality. Lending under an ESM program is coupled with painful adjustment programs and will, *ex post,* impose those reforms to restore competitiveness and fiscal capacity that were neglected *ex ante.* Restructuring and tight surveillance under an ESM program should significantly reduce the risk of a speculative attack and the forced default of a distressed member country.

These developments should be complemented by further reform: (i) by strengthening the financial capacity and institutional independence of the ESM, maybe elevating it to a status similar to that of the ECB or the IMF. The mission of the ESM is to provide conditional lending to distressed member countries coupled with tight surveillance of adjustment programs; (ii) tighter regulation and more ambitious recapitalization of the European banking sector. Higher equity standards will make banks more robust and reduce cross country contagion in an integrated capital market. They are also a precondition for more prudent lending and for banks to better exercise the required market discipline; (iii) revising the fiscal compact. After a transition towards low target levels of public debt, the debt brakes must allow for sufficient flexibility, so that automatic stabilizers can dampen short-run fluctuations.

Recent developments and further reform could internalize a large part of negative spillovers of irresponsible fiscal and economic behavior to other member countries. In a union with very heterogeneous cultural values and preferences, large scale transfers and interregional redistribution are likely to be a constant source of political tensions, quite in conflict with the political goals of establishing peace and harmony in Europe as a result of economic unification. By contrast, economic and institutional reform as suggested above should prevent, or at least significantly reduce the negative consequences of national decisions on other member countries, and would be more in line with the political goals of European leaders.

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Exit from the Monetary Union – A Free Choice by Greece

Martin Seidel*

Greece's membership of the monetary union is not compulsory. Greece is free to give up its membership of the European Union at any time. The other member states cannot prevent Greece from leaving the European Union. From a strictly legal point of view, Greece can neither 'leave' nor 'join' the monetary union. For the monetary union is no association of countries that a state can 'join' or 'leave' like a club or an organisation. All that stands behind the so-called monetary union is the competence and responsibility that has been transferred to a European level to design a common central monetary policy for the member states of the European Union. Monetary policy is, like for example the European Union's fisheries policy, a so-called exclusive policy of the European Union, alongside which there is no complementary policy formulation on a national level, unlike for agricultural policy, for example. Regardless of its classification as an exclusive policy, the scope of the common monetary policy can be territorially expanded and restricted *via* exceptional regulations, as in other policy areas. A restriction in terms of the fishery policy, for example, occurs in that Greenland was retrospectively excluded from the European Union's fishery policy as part of Danish state territory. There was no talk of Denmark even partially leaving the 'fishery union' of the European Economic Community.

Despite Greece's involvement in shaping the European Union's common monetary policy *via* the board of governors of the European System of central banks, the euro remains a foreign currency for Greece. As a foreign currency, and unlike a national currency, the euro is not an *economic accounting device* tailored to suit the Greek economy, i.e. unlike a national currency, it does not act as a 'measurement system' that reflects the economic performance of an economy compared to all other competing economies in figures. The monetary policy of the European Central Bank and/or more specifically of the European System of central banks is not oriented exclusively towards Greece's economy and cannot be compared to a national currency in this respect. Since European monetary policy, like any monetary policy, can only be formulated in a standardized fashion, it cannot even orientate itself primarily towards Greece's economic policy concerns due to the small size of Greece's economic area. Greece is not a territorial component of an integrated European economy, but continues to have an economy that is based on its own sovereign statehood and its own laws, just like all other member states. Despite some co-responsibilities borne by the European Union in the field of the so-called policy of economic and social cohesion (fund policy), economic policy remains primarily the responsibility of member states, even in the wake of the Maastricht and Lisbon treaties. The common market designed by the European Union may connect the economies of member states, but it is institutionally limited to the realisation of four cross-border economic freedoms: namely for the cross-border intra-community flow of goods, services, persons and capital; while also acting as a customs union and hosting a central competition authority. The common market or single market has not merged the economies of member states into an integrated economy to date, and will only achieve this to a limited extent at best in the future given the lack of any provision of community public goods, which must be centrally offered by an economy. Despite the expectations placed in it at the Maastricht Conference, which the current debt crisis in several member states of the monetary zone has shown to be misguided, the European Union's monetary policy did not *ipso facto* lead to converging economic development in all member states, thereby creating the conditions for a true merger of the economies of member states.

Greece will be 'struck by Apollo' (Friedrich Hölderlin), if it does not distance itself in the short-term from the course followed by the European Union since the outbreak of the sovereign debt crisis

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in 2009 to address the excessive debt burden carried by Greece and other high borrowing requirements on the part of crisis-hit member states of the monetary zone. The draconian (economic adjustment) programme imposed on Greece of rigorous cuts to state spending and across-the-board increases in taxes and contributions was imposed on Greece as a 'return service' for financial support from the European Union, member states and the International Monetary Fund with a view to the 'recovery' of its creditworthiness as a member state of the eurozone. This will not, in all likelihood, lead to a successful outcome, but to the absolute economic demise of the country, with lastingly high collateral social costs for its population as a result. In terms of numbers, Greece can become economically stronger and competitive 'with or thanks to a miracle' (from Israel) at best if it remains inside the monetary zone and does not give up the euro as a foreign currency. Only a haircut, which in itself would not be sufficient to enable Greece to remain a member of the monetary union, along with the reintroduction of its own national currency, would give Greece a chance to recover economically.

Now that the 'draconian' economic adjustment programme imposed on Greece over the past two years has proven ineffective, the view should very soon start to prevail in Greece that an economic fresh start outside the European Union is preferable to the country's demise, which looks likely at present. This view should prevail even if such a fresh start were to take place in undoubtedly harsh economic conditions, for it would at least offer the hope of a better future and of real financial economic support, instead of the purely fiscal assistance provided to date. The history of the numerous cases of state defaults shows that Greece will not be entering rough, uncharted terrain. The circumscribed new start may, if properly managed, very quickly restore Greece's creditworthiness if the economy can be successfully boosted. Greece should feel no obligation to safeguard or preserve the monetary union. Neither the monetary union nor the euro as a single currency will be endangered by Greece taking 'time out' from participating in the monetary union. Indeed, the monetary union and the process of political integration in Europe is far more likely to be strengthened by Greece leaving the currency zone and the anticipated fresh start for its economy arising from such a move, than that such a politically reasonable step should call into question achievements to date in the process of European unification. The Maastricht regulatory system for monetary union provides for member states that do not satisfy monetary union membership conditions to participate in monetary union in an appropriate way via their participation in the European Monetary System II – in its so called first and second level – as 'member states with an exceptional permit' outside the monetary zone, and to participate in the integration process on an equal footing.

Should the view prevail in Greece on a political level that the country should replace the euro as a foreign currency with a new national currency (the 'euro-drachma') and the Greek government should signal Greece's exit from the European Union, then the latter would have to take action immediately. In view of the danger of speculative capital flows, there should neither be objections on the part of other member states nor an overly public discussion of the issue. It may be necessary – as in the case of previous exchange rate realignments within the European Monetary System (EMS I) – to close the stock markets immediately and other, tested measures may have to be taken by the European Union and the other member states. Any denial of technical assistance on the part of other member states would raise the question of an infringement of solidarity, if not of European Union law.

An immediate statutory requirement to act would arise both on a Greek national and on a European level.

Despite its membership of the European Union and the monetary zone Greece has sufficient sovereign powers to reintroduce its own currency immediately, without the authorisation of European Union legislators if necessary, to declare itself fully or partially insolvent by law, and to take all of the requisite legislative measures in this case. Neither the introduction of the euro as a currency and legal form of payment in Greece, nor recourse to the European Union's competence in shaping monetary policy as a so-called exclusive policy have led to the quasi in rem destruction of Greece's powers to act in the area of monetary and currency system, which could not be reinstalled without a change to the Greek constitution or without an authorizing legal act by the European Union. The authority of the member states to leave the European Union autonomously and established by the Lisbon Treaty is based on the continued existence of all national sovereign jurisdictions after member states join the European Union, despite the fact that the national jurisdictions affected by the granting of rights to the European Union

can no longer be exercised autonomously without the member states in question potentially being held accountable for an infringement of European Union law. The autonomous reintroduction of a national currency by Greece that is thereby made legally possible, without any prior abolition of the euro as a currency for Greece *via* a European Union legislative act, would be seen as 'violating European law' or an infringement of the rule of union law. However, as a direct result of the Greece's 'exit' from the monetary union, which has been declared permissible, the other member states of the European Union and its legislator would be obliged by European law to immediately revoke all regulations opposing the reintroduction of a national currency in Greece, and especially and in the first instance, the validity of the single currency for Greece. The member states and the bodies of the European Union, in the opposite sense, acted very innovatively, but correctly at the time when the German government included five new German Länder as well as East Berlin autonomously at first in the purview of German constitutional law on the occasion of German reunification on 3 October 1990, thereby extending the overall sovereign and territorial area of validity of bodies of the European Union to all of reunified Germany without passing any legislative act.

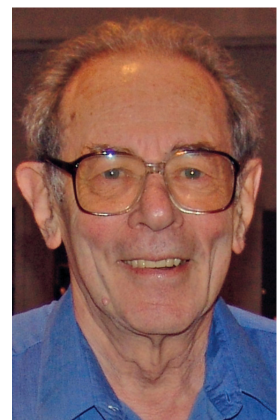
The European Union and its member states cannot raise any political objection to Greece's wish to leave the monetary union, and specifically cannot claim that any member state other than Greece would incur 'significant costs' related to the latter's exit. If, after weighing up the pros and cons, Greece is prepared to shoulder all of the 'social and economic' costs arising for the country if it gives up the single currency because it backs this solution and believes that it can only boost its economic performance, with financial assistance from other states or international organisations, by leaving the monetary union, there is no room for reservations on the part of other member states, and not even if there are objections regarding the disadvantageous consequences of an 'exit' for other member states or the monetary union. The solidarity required from all member states demands that Greece should not be prevented from taking responsibility for its own destiny either by horror scenarios or by the threat of sanctions. The euro as a foreign currency has had catastrophic economic consequences for Greece and will continue to do so in the future if, after the obvious failure of the 'bail-out measures' of the European Union, this disastrous side-effect on Greece is not cancelled out by its exit from the monetary union and Greece's reintroduction of its own currency. The commonly cited horror scenario of a member state leaving the currency zone also merits closer scrutiny. The servicing of debts quoted in euros, which would nominally grow by the devaluation rate after the anticipated devaluation of the newly introduced national currency against the euro, are no longer an issue if Greece legally declares its insolvency and nominally converts all state and privately issued bonds into the new currency, or defaults on payment entirely. Rising import prices, which are also menacingly cited, will be opposed by falling export prices, meaning that the comparative cost advantages of the Greek economy should, on balance, result in an increase in prosperity in tourism at least. Inflationary trends can be counteracted and curbed by an appropriate central bank policy and also should not be seen as an inevitable result of any exit. Similarly, capital flight, if it should occur, can be counteracted by legislative measures; and this fear should not prevent Greece from reintroducing its own currency and undertaking a haircut. Domestic banks, or their foreign counterparts with investments in Greece, that are on the verge of collapse can be supported by equalization claims if they are deemed capable of survival, as shown by similar cases in the past. A trustworthy Greek government, especially if supported by other member states and the European Union, could even try with some degree of success to counteract a bank run, which is realistically the greatest fear, by following the German government's example in 2008 on the outbreak of the global financial and economic crisis.

Centralization and the Capitalist Market Economy in Hungary

János Kornai*

Not long ago I was shown the quotas for admission that the faculty of economics at a provincial university had received from the Ministry for the ongoing academic year, which were derived from the national admittance threshold points: students on basic training 750, students on the masters' course 120, etc. I could hardly believe my eyes. Exactly 120 students on the masters' course? Not 119 or 121? I got in touch with people at other universities, who confirmed that they too had received similar detailed numerical quotas from the higher authorities. None of these university staff members could tell me quite how the figures had been calculated, but they suspected that someone above had produced aggregate national quotas for the each major field that had been broken down to an institutional level.

I had a flashback to 55 years previously. Back in 1956 I was working on my dissertation and holding regular discussions with enterprise managers in light industry. They spoke scornfully of the meticulous plan directives they received from the ministry, laying down for the following year, fabric by fabric and width by width, how many square metres of woollen or cotton material they had to weave. How, they exclaimed, did 'the powers that be' arrive at these exact figures given all the uncertainties of production and sales? Based on my research I finished my dissertation, which after some upsets appeared in 1957 as *Overcentralization in Economic Administration.* Over half a century has passed since then, and not for decades did it occur to me, even in my wildest dreams, that the subject of my first book, overcentralization, would ever become opportune again. Yet this is now the case. The subject of this article is the centralizing tendency strongly apparent over the last twenty months.



My article 'Taking Stock', published in *Népszabadság* on 6 January 2011, reflected on the events of the Orbán government's first eight months and the public debate over them. It tried to explain how a radical change had occurred in the political structure: Hungary was no longer a democracy, but an autocracy. In close relation to this development, the article reviewed the damage done to legal security and human rights, and the detrimental features of the economic policy pursued by the government. Another twelve months have gone by, in which the critics of the Fidesz regime have produced numerous in-depth analyses and vehement political statements. Broad agreement on the situation has emerged amongst thinkers committed to democracy, human rights and the rule of law.

This article does not call for any changes of emphasis. I am still convinced that the main problem lies in the replacement of democracy by autocracy. What I set out to do here is to add to the conclusions already drawn, by reviewing the events of the last twenty months from a *different angle:* that of the centralizing tendency.

Examples

I will begin with examples rather than definitions, not grouped in order of importance, but presented sector by sector of society and the economy. The examples will illustrate what is meant here by a 'centralizing tendency'.

(a) Ministries

The government replaced in 2010 had twelve ministries. This number under the new government has been reduced to eight.

(b) National Bank of Hungary

The new act on the central bank was passed by Parliament in a whirlwind of year-end activity. At first sight, this new piece of cardinal legislation pre-

* Collegium Budapest – Institute for Advanced Study. This is an English translation of the article 'KÖZPONTOSÍTÁS ÉS KAPITALISTA PIACGAZDASÁG' published in the 28 January 2012 issue of NÉPSZABADSÁG.

scribes only formal changes, but in political practice, it allows strategic direction of the National Bank of Hungary to be assumed by the Fidesz regime, whose will also prevails over the government's actions, the president of the republic, and through its two-thirds majority, the legislature. The decision-making powers of the Monetary Council have been boosted. The prime minister may recommend a further National Bank deputy president alongside the two existing ones; his recommendation will undoubtedly be accepted by the head of state. Four new members have already joined the Monetary Council under the Orbán government; now two further appointments can be made. This put the members appointed by the Fidesz regime in a numerical majority, which may become stronger still, in a body where decisions are taken by majority vote. The position of the president of the National Bank is insecure. The transition rules associated with the country's new Basic Law allow the National Bank and the Hungarian Financial Supervisory Authority to be merged. Whether or not such a merger will be useful, it provides an opportunity to create a new united institution, a 'superstructure' to which a new leader can be appointed, thus demoting the president of the National Bank. Nobody knows whether the new legislation on the central bank will be long-lasting or not. This article does not engage in guesswork. Nonetheless, the mere fact that these very important pieces of legislation have been passed, despite protests at home and abroad, shows the force of the centralizing tendency, in other words of the determination of the top leadership to concentrate all powers into its own hands.

(c) Supervisory and regulatory bodies

Before the change of government the Budgetary Council had a significant staff working *in parallel* with the Finance Ministry. They made similar calculations to those of the government machine, but independently of them. The parallelism has ceased; the Budgetary Council will have no staff of analysts of its own in future.

There used to be four ombudsmen (parliamentary commissioners) working in parallel. Under the new regime there will be one. They used to speak as the conscience of Hungary's citizens – now this activity is to be part of the machine of the state.

There was a Health Insurance Inspectorate set up under the previous government, with tasks differentiated from those of the National Public Health and Medical Officer Service and the Health Ministry of the day. The Inspectorate has now been abolished, and its tasks passed over to other authorities or left unassigned.

(d) Armed forces

The Customs and Finance Guard has been merged with the Taxation and Financial Control Office to form the National Taxation and Customs Office.

A Counter-Terrorism Centre has been established that combines the functions of several hitherto separate organizations. A former chief bodyguard of Prime Minister Viktor Orbán has been appointed to command it.

The Hungarian Corps for the Protection of Order will be established in a curious, semi-state-controlled, 'corporatist' form. All members of law and order bodies will be obliged to enter the Corps, which will act as an interest-protecting body. This mission will, to some extent, squeeze the trade unions out of the representation process.

(e) Local government organizations

The new local government act deprives local government organizations of four main groups of tasks. Let me emphasize here that, in future, education, the health service and disaster protection will be wholly the responsibility of the central government.

Most of the state administration local services have been merged into the county-level government offices. This applies to land offices, pension institutions, and the consumer protection authority too. The county officials heading these offices are to be appointed by the prime minister.

(f) The judiciary

Hungary's courts of law were previously directed by an independent body with a specific form of self-governance. This has been replaced by a National Judicial Office, whose head is chosen by Parliament (in other words, the leadership of the party in power at the time). At present, this function happens to be performed by the wife of one of the most influential men in Fidesz. She decides personally on the appointment and promotion of judges. She also determines which cases shall be tried by which court.

(g) The media

The Media Authority (National Media and Telecommunications Authority), as the paramount state body for media matters, resulted from the merger of

several organizations. Its province extends from the content of television and radio services to the allocation of frequencies. Alongside the Media Authority, a so-called Media Council exists, whose members are drawn exclusively from political forces in the government.

Previously the state-owned, publicly financed radio and television channels operated separately, as did the state news agency. Now these entities have been merged into a giant centre called the Media Service Support and Asset Management Fund. This centralizes financing, and no less importantly, has the power to choose, hire and fire staff. Before the merger, the public radio and television departments could choose their own news sources. Now they are all obliged to use the material disgorged by the central news office.

(h) Insurance

Reforms in the 1990s produced a pension system that rested on three 'pillars', namely compulsory state insurance, compulsory private insurance, and voluntary private insurance. In 2010–2011 most of the second pillar's assets were seized and much of the funds were spent by the government, while its obligations to the insured are theoretically transferred to the first pillar, the state pension system.

The commercial banks set up and funded their own insurance body, the National Deposit Protection Fund, to guarantee repayment of deposits in times of disturbance in the banking sector. Government pressure has obliged the banks to hand over the management of these assets to a state body, the Government Debt Management Agency.

(i) Services

Seven previously separate companies in Budapest running the medical spas, street cleaning, funerals, etc. have been merged under a holding company, which also represents the capital city on the boards of the private and semi-private utility companies (gas, water, etc.).

Trade in tobacco products is being nationalized. The number of retail outlets will fall from 40,000 to 5,000.

It has already been mentioned that the county hospitals will pass from the control of the county self-governance authorities to central government. These changes of ownership can be expected to coincide with mergers and closures that reduce the number of institutions, while providing chances to appoint new chief executives.

Disposal of sewage in parts of Budapest without sewage mains has been conducted by private sewage-tanker operators. This will be taken over by a firm owned by the capital city. The changeover is being accelerated by a financial disincentive: those using private operators will pay twice – namely, the full price to the private operator and the full price again to the city-owned company.

(j) Education, the arts, science and scholarship, entertainment

As mentioned earlier, primary and secondary schools in local government ownership are being transferred to central government. Control over *gymnasia* (academically-oriented secondary schools) owned by the capital city has already been centralized under a new Economic Organization for Gymnasia. Previously the appointment of teachers was the principal's right; now the Economic Organization has to agree to appointments. Each gymnasium previously had control over its own funds. Now it may spend nothing over a few thousand forints without the approval of the Economic Organization. By the time the gymnasia get used to these rules there will be further centralization, as they pass into central government ownership.

According to the cardinal act on public education, we are hurrying towards a uniform, central curriculum. Teacher independence will largely cease: 90 percent of what is taught will be compulsory curriculum and only 10 percent optional. Previously, local government-owned schools had greater freedom to adapt their curricula to local conditions; now they will all be inflexibly standardised.

The universities did not have full autonomy before, but now their quasi-autonomy is being strongly curtailed. The appointment of a rector was a two-stage process in which the university senate chose one candidate from several and s/he was then appointed by the government. No rector could be appointed unless recommended by the senate, although the government had a scarcely exercised right to veto a candidate. From now on this process will be different. The rector will be picked and appointed by the government. University bodies will only have the right to express an opinion, not exercise a veto, even if they disagree. As before, the seal will be placed on the document of

appointment by the president of the republic. In other words, the essential aspect in the selection process has passed from the hands of the university into those of the central government.

There is a wave of centralization engulfing the Hungarian Academy of Sciences network of research institutes. Various institutes of natural and social sciences with strong reputations that have worked separately and independently for several decades are being herded into groups and subordinated into newly created centres.

Mergers and centralization are occurring in vocational training and integrated training centres are also to emerge.

To date the public funding for several arts and science-related activities and social welfare tasks was distributed by public foundations, some of which amassed considerable assets. They embodied a specific form of professional autonomy and self-governance; boards of trustees consisted of representatives of the art or science concerned, or of experts involved in welfare activity; and the subsidies awarded were decided in line with their professional consciences. Most of the public foundations – 24 in number – have been abolished and their assets and decision-making functions transferred to state authorities.

The 1956 Institute, a previously independent body, has been annexed to the National Széchenyi Library. The Lukács Archives have similarly lost their independence, by being subsumed into the library of the Hungarian Academy of Sciences.

The Budapest State Opera is being run by a government commissioner appointed not by the minister of culture, but personally by the prime minister. The Museum of Fine Arts and the Hungarian National Gallery are being merged. So is the Mikroszkóp, a cabaret theatre, with the Thália, a theatre devoted usually to serious drama.

The Budapest Assembly has resolved to merge Petőfi Hall with the Trafó House of Contemporary Arts. The Budapest Gallery will merge into the Budapest History Museum.

The state funding for film production is being centralized. Andy Vajna, the government commissioner, is demanding the ‘right of final cut’ on the films mainly funded by the state.

What the examples have in common

It would be easy to add to the list of the thirty-three examples that I have given, which purposely ranges from the massive transformations involved in winding up the second pillar of the pension system, or the powerful new central office jeopardizing the independence of the judicial system, or the new law on the National Bank, to the smaller changes of amalgamating two galleries or amusement venues, although the latter will also bring radical changes for those involved. The range of examples includes some tiny or even bizarre instances to demonstrate how centralization has turned into a widespread merger mania. Wherever a problem is perceived, the panacea is to centralize and amalgamate. I would like to convey how the accustomed operation of countless organisms in society has been upset by the accelerating waves of transformations. In fact, a sudden reorganization is taking place in so many areas at once that it is justified to cite the Hegelian formula: quantitative change has become qualitative; the changes taken together have radically altered the system of control. Notable ingenuity has gone into this process: the legal form of the changes varies from case to case. In some cases whole institutions are united, in others the procedure for appointing heads has been modified, sometimes executive boards are packed to increase central control, sometimes statutes are altered. So what ‘pattern’ emerges from all thirty-three cases?

All state bodies are necessarily centralized, but the centralization *within* the machinery of state will strengthen if (i) the superior has fewer subordinates, so that his/her capacity for direction and inspection allows him to control them more firmly. Centralization will strengthen if (ii) there are fewer levels of superiority and subordination and if (iii) the commands become more detailed. It helps if (iv) the top political leadership is able to appoint its own people to all important positions. In terms of society as a whole, centralization grows if (v) previously autonomous activities operating *outside* the machinery of state can be brought, partly or wholly, under state control. Finally, centralization grows if (vi) state inspection and intervention can take place in processes previously not subject to such control.

In each of the examples at least one of the changes (i) to (vi) can be shown to have occurred. There are some cases in which two or more of the changes appear. This in itself backs my assertion that we are not facing a random collection of changes here. All the

changes listed point in a clearly perceptible *direction*: they reinforce centralization. I term this strong, radical, clearly observable and dizzyingly rapid process of transformation as a *centralizing tendency.*

I introduce here a neutral term free of value judgement, in line with a positive, scientific approach. Normative analysis and value judgements will follow later in the article. Even those who approve of the changes surely cannot deny the existence of such a centralizing tendency.

Some of the new formations, legal stipulations and forms of organization can be found under western democracies, but there they do not attack the foundations of democracy *as such.* The specificity of Hungary's twenty-month transformation is that this government has introduced *a great number of concurrent moves* towards excessive centralization and the destruction of autonomous mechanisms, and these very varied, mutually reinforcing changes have combined to form a trend.

Arguments for and against

The official initiators and implementers of these changes tend to claim that the previous form of organization or mechanism was inefficient and wasteful, and led to sluggish handling of affairs. There is no denying that problems of this kind could be found in almost every case. They go on to argue that there is one universal remedy for low efficiency and tardiness: merging units, eliminating overlaps, pruning out excess capacities – in a word, strengthening centralization.

There is an age-old debate over the advantages and drawbacks of centralization and decentralization. Names such as Adam Smith, Marx, Hayek and Lenin spring to mind, along with those of the great figures in mathematical economics, the Nobel Prize winners Arrow and Hurwicz. I thought, naively, that such debates could only recur in Hungary in university seminars on the history of economic theory, as intellectual titbits. Sadly, I have been proved wrong: the debate over centralization has become highly topical once again. Remaining on the fine, smooth plane of theoretical analysis, I will try to contrast the arguments for and against centralisation.

The multiplicity of human activity has to be coordinated, with the assistance of various mechanisms. One such mechanism is that of *vertical coordination.* Let us imagine a pyramid. At the top is the Supreme Chief, who gives orders, let us say, to ten Chiefs beneath him. Under them lies a wider level of Deputy Chiefs. Each Chief has several subordinate Deputy Chiefs, while each Deputy Chief is subordinate to only one Chief above him. As we go down the pyramid, past the Deputy-Deputy and Deputy-Deputy-Deputy Chiefs, the levels become wider and wider and the number of participants increases. Finally, we reach the base of the pyramid. Here stand all the many people who receive orders from above, yet do not, in turn, direct anyone beneath them. This formation is termed in theory a 'perfect hierarchy'. (How devotees of centralization must sigh to think of it!) It is supposedly perfect because the relations of superiority and subordination are unambiguous: there are no double or multiple lines of dependence.

Another model is the mechanism of *horizontal coordination*. This operates on a flat plane; nobody is subordinate to anybody from the outset. The participants have to agree amongst each other. The first model is a pure case of centralization, the second one of decentralization. In the first model the hands are visible: the chief's order is a warning, and if need be, a threat. In the second, to use Adam Smith's apposite phrase, the coordination is effected by an 'invisible hand'. A formation similar to the first model is embodied in the state (although never in such a pure form as the model describes). Two spheres resemble the second. One is the market, where the coordination is motivated by discernible material interest through agreements between buyer and seller. The other horizontally coordinated sphere encompasses non-profit organizations, the various free partnerships and associations, the groupings of 'civil society'. Here the motivations are a mixture of material and non-material incentives.

Let us contrast the characteristics of centralization and decentralization.

1. *Short-term efficiency.* Decentralization is obviously accompanied by wastage. There are parallel organizations whose activities overlap. A marked proportion of the capacities remain unused. So merging several bodies under central control produces instant savings in administrative costs; some personnel can be dismissed straight away. (An example is the administrative costs of decentralized private insurance, which are certainly higher than those of a centralized state insurance system.) This argument always rings out triumphantly. Yet the beneficial

effect cannot always be counted upon, because the centralizing measures are usually pushed through hastily, at a forced pace, without the benefit of sound expert advice. Eliminating overlaps, cutting administrative costs, and a *short-term* increase in efficiency add up to a weak argument, even though they produce results, because other arguments for and against must be considered carefully.

2. *Competition*. Centralization involves cutting out competition wherever possible, whereas rivalry is vital to decentralization, although competition involves great costs. Competing sellers have to advertise and convince buyers to purchase their product or service, and not those of another. They have to keep free capacity available to meet buyer demand at any time. This ties down huge resources superfluous to a centralized economy; but competition generates a huge driving force. It makes it desirable, and even essential, to launch new products before competitors, which is the engine of the innovation process that transforms our lives. All the major innovations in the last century have been made by decentralized, competitive economies.

Competition is necessary not only in the narrow sphere of economic activity, but in education, science and the arts. One very talented economist graduating from Harvard University wanted very much to teach there, but he was turned down. He then applied to the nearby Massachusetts Institute of Technology (MIT), where economics had not been taught before, and offered to set about organizing a teaching programme for it. He was given the chance. (He was lucky not to be dealing with Hungary's Ministry of National Resources, which knows beforehand precisely how many students it wishes to see in how many departments of how many universities.) The economist's name was Paul A. Samuelson, who would later become the most famous economist in his country and the first American economist to be awarded a Nobel Prize. Today MIT is one of the world's best-known workshops for teaching economics. Since then, the economics departments of the two neighbouring universities have rivalled each other ('overlapped'), vying to be the department with the best students and the most valuable research results, and frequently poaching each other's staff. Despite the rivalry, there is nevertheless cooperation between them in the form of joint seminars, for instance.

3. *Adaptation and selection.* Hungary's centralizers think it is possible to plan accurately within the four walls of an official building: to lay down future structures in legislation and other inflexible regulations, freed of overlap and multiple administrative costs. It becomes possible to gauge the huge advantages of decentralization only by observing the *movement* of society. New organizations are continually appearing, some merge, others split, while others are wound up. Small, medium-sized and large organizations appear and thrive side by side. Some grow, others shrink. This all resembles in many respects the evolution and natural selection found in the biological world.

The birth and massive growth of Google or Apple did not result from a position taken by some jury assigned to assess tenders. No ministry decided whether or not the Metropolitan and the Guggenheim Museum, situated a couple of hundred metres apart in New York, should amalgamate or remain separate institutions.

Viable products, technologies, management methods, teaching principles, forms of organization, and organizations themselves stay alive. Those incapable of adapting and improving themselves fall away sooner or later. What arrogant self-confidence, what belief in one's own infallibility it takes to think that an office or a chief should decide on matters of life and death! Decisive, irreversible transformations are decreed, not gradually, experimenting along the way, as evolutionary processes take place, but at breakneck speed, to be accomplished in a matter of days or even hours.

4. *Information*. One condition for centralized coordination to work flawlessly is for the decision-maker to predict just how events will develop. In that case a flawless decision can be reached, and all that need happen is for the decision to be vigorously imposed. Real life, however, is full of uncertainties and inaccurate information which is not necessarily fortuitous; there may be intentional distortion at work. It may suit subordinates to deny that there are problems (or exaggerate them if it serves their interests). They may report that there is spare capacity, or on the contrary, complain that there is excessively tight utilization of capacity, depending on which is to their advantage. The Chief will be unable to correct faulty decisions because subordinates dare not tell him he has erred.

Here decentralization has a big advantage. Those collecting information are often the same as those who apply it, so that there is a personal interest in making it accurate. (This, in a very brief, rather simplified

form, is Friedrich von Hayek's main argument for decentralization.) Those acting on faulty information pay the price: they drop out of the running, they are deselected. Those who stay in the system are open to information, criticism and self-correction.

To sum up the arguments under points 2, 3 and 4, it can be stated that horizontally coordinated decentralization is much more *efficient in the long-term* than centralized, vertical coordination. If these arguments (presented in much more detail in the vast body of literature on the subject, of course) are considered objectively, it will be seen that the statement is true on a straight *logical* basis. However, there is also more cogent and succinct practical evidence available to support this statement too. The socialist system in its classic, Stalinist form is the historical structure that moved closest to a 'perfect hierarchy', to the model of utterly vertical coordination. Lenin stated that the Soviet system could be seen as one gigantic factory. The system initially, in the short-term, brought spectacular results indeed, but in the end it failed! In its long-term efficiency (in terms of innovation, productivity and continual expansion of production), it fell far short of the performance of the decentralized capitalist system.

The efficiency of a system is essential to increasing material welfare, but there are other values to be considered as well.

5. *The value of independence, self-determination and autonomy.* Let me take education and training as an example. It is clearly important for supply and demand for labour to harmonize, and so for the recruits emerging from training to match the structure required by their likely workplaces, in terms of level and type of training, etc. I once heard the following line of argument put forward at a conference in Sweden. Mozart's father might have learnt from the fact that Salzburg was full of musicians. Nannerl, the elder daughter, had become an accomplished pianist. Perhaps little Wolfgang should be a skilled craftsman instead: there was shortage of those too.

What moral grounds are there for rigid defining what young people study? What happens to the sovereignty of the individual and the family in such cases? It may be that regional or professional autonomous bodies make many mistakes. It may also be that a super-clever state office can reach better decisions. However, there is an *immanent* value for many in allowing a village, a town, a profession, a branch of art, or any other community to decide for itself. István Bibó wrote of the 'little circles of freedom' when he argued for self-governance.

6. *Paternalism and self-care.* The more the centralized state coordination embraces society as a whole, the more the state receives the task of taking care of all its citizens in every respect. Centralization and paternalism are twins, as are decentralization and self-help. This is an argument in favour of centralization in the eyes of those who like to depend on the state, but not everyone does. There are those who distrust the caring state, and many more have become uncertain about it in the light of recent developments. What if the state does not keep its promises? What if it turns out to be a father who does not look after his children well? Furthermore, many of us dislike being treated as children. We want to be responsible for ourselves. We want to provide for ourselves and our families, though it may involve greater expense. It brings to the fore private insurance, credit possibilities for paying education costs, and other decentralized mechanisms. There is no need for an unnecessarily sharp contrast: the demand for solidarity calls for the state to play a big part in assisting the sick and the old, disadvantaged and destitute. Nonetheless, the value of self-help, responsibility for oneself, is a sound argument for a requisite measure of decentralization and against an excessive degree of centralization.

7. *Diversity*. There was a huge saving for the Chinese economy when it became compulsory for all to wear a 'Mao suit'. How light-industrial costs must have jumped when multicoloured garments reappeared! Since then, the Chinese have shown by their purchases that diversity is a luxury for which they are willing to pay extra.

Turning to a broader definition, our diversity is one of the beauties of life. There is no need to shepherd several research stations or several schools into one pen, even if they cost more separately. Each has its own history, its own tradition and its own collective memory. They have been through lean times together and developed a sense of community. These cold-blooded, technocratic reorganizations break such communities up, rob organizations of their past, and place them artificially in new, alien surroundings.

8. *The political criterion.* So far I have considered criteria of efficiency and of ethics. I have left the political criterion to last. Let us lay aside points 1–7 for a moment and assume there is a well-oiled, smooth-

running mechanism in operation. The question is who stands at the top of it? This is a question customarily asked in theoretical literature on the subject, and answered with the assumption that a 'benevolent dictator' stands at the top of the pyramid.

Yet what happens if this benevolent person is fallible and prone to making frequent mistakes? If his or her intentions are not so good, and s/he tyrannizes, welcomes flattery, rejects criticism, shows obstinacy, and proves incapable of requisite adaptation? That may be the worst problem with the centralized model. The more efficiently it works, the greater the danger of it becoming the tool of a tyrant. Mechanisms based on decentralization, on the other hand, contain 'checks and balances' against such an all-powerful centre. The more decentralized mechanisms there are and the livelier their activity is, the more firmly they offset the centralized peak of the pyramid. The politicians and pundits who aim for a strong state for the sake of fairer distribution and redistribution in favour of those in need should bear this in mind! Beware: leadership of a strong state can fall into the wrong hands!

Power and centralization

Evaluating arguments for and against centralization based on the eight criteria mentioned belongs to the field of *normative* analysis. We have weighed up in various contexts whether the centralizing tendency is 'good' or 'bad'. Let us now turn to a *positive* approach of considering the observable phenomena of reality and their causes and consequences.

The main ambition of the government led by Viktor Orbán has been to grasp power as firmly as possible, and having done so, keep hold of it as long as possible. Power is the *end* and all *means* are subordinate to it. If we have understood this Machiavellian relation of end and means correctly, this is most important causal explanation of the centralizing tendency. The power motive provides sufficient cause to make the Orbánite pyramid as comprehensive and effective as possible. The true motive for the changes is to bring about the following conditions as much as possible:

- Let the chain of command from the top downwards be as short as possible.
- Let every Chief, Deputy Chief and Deputy-Deputy Chief be one of our trusty people. The reorganization of all organizations is justified by the opportunity provided to appoint our people to head the new Centres or Sub-Centres. Nor need we stop at posts traditionally reserved in the practice of democracies for 'political appointees'. The further down the pyramid we insert our trusted employees, the better.
- The main appointment criterion is loyalty to the top of the pyramid. Of course, expertise is useful as well, but unconditional loyalty and obedience are paramount.
- Whatever level of superiority/subordination pair it is, let the dependence be *strong*. Orders must be obeyed without question. In fact, subordinates need not wait for orders. They will know from the party line what superiors expect and act on their own initiative.
- Bosses need not have long discussions with subordinates. As in the military, the pattern for vertical coordination, the essence lies in the downward flow of information, the orders, not in the upward flow of suggestions or advice, let alone criticism.
- The condition for the operation of centralized vertical coordination is discipline. This must be imposed by administrative means. The disobedient must be dismissed. Nor is there any harm in clean-outs of workplaces where nobody was considering disobedience. (Examples are the mass dismissals from the public media and from the ombudsmen's offices.) I have even heard of cases where the regime has followed up by preventing dismissed officials from finding new jobs. Fear of dismissal leads many to humiliate themselves, preferring to smother their protests rather than to risk their jobs.
- Naturally, vertical coordination rewards its people as well as punishing and threatening them. Loyal service brings high pay, end-year bonuses and special non-monetary concessions.

The power motive does not simply apply at the top. Going down the pyramid, the new nomenclature of 'our people' reaches to deeper and deeper levels. Its members – Chiefs, Deputy Chiefs, Deputy-Deputy Chiefs – have themselves attained power. They must comply with those above them, but can command those below; and having attained power, they hold onto it. The Supreme Chief at the top of the pyramid is not alone: he has shared interests with the high, medium and low-level powers beneath him, in maintaining and retaining power.

Life for the new nomenclature on the upper levels of the Orbánite pyramid is eased because they do not

have to philosophise or rethink complex dilemmas repeatedly. They have to do their part as the party and government orders and expects. If there is trouble, the medium and low-level bosses have a ready excuse: 'we can't help it, the decision taken higher up was faulty'. (How familiar is the line, 'I was carrying out orders'.) The reassuring technocratic ideology is also at hand (see criterion 1 in the previous section): 'we are building and strengthening centralization for the sake of efficiency, and not for power's sake'.

Vertical coordination – the hierarchical system of command – has never worked satisfactorily anywhere. It is a squeaky machine. If troubles arise, the inner logic of the mechanism calls for more centralization. If detailed instructions are evaded, the numbers are broken down further. 'Hand-piloting' is not exceptional, so that each boss himself decides, instead of giving general guidelines to his underlings.

According to the logic of a centralized system, the greater the troubles, the more administrative measures must be applied. Once upon a time it was termed 'sabotage' for an enterprise to miss its plan target and the penalty in the Soviet Union could be death or merciless forced labour. The byword now is 'fraudulent misuse of funds', and in rare cases where this has been proved conclusively in the courts, the sentence, so far as I can judge, has remained within the bounds of a civilized judicial system. However, there is no guarantee that repressive measures will stop there. Further curbs on the legal rights of witnesses or suspects reinforce concerns on that score. Arbitrary accusations and false charges are becoming more common. It must be feared that public officials and business figures will be enveloped by a threatening atmosphere. Against this backdrop, we must place our hopes in the legal sense and professional honesty of the judges. Punishment must come to those who break the law, but only to those who really do so. Pressure is being applied to the judiciary; judges face a great test; but conscientious judges will not pass falsified or prejudiced sentences and judgements.

All I have said here about the attributes and inner logic of centralized vertical coordination will come as no surprise to those familiar with the socialist system. The problem is that the Fidesz regime has mistaken its period. Strong centralization was able, for better or for worse, operate and survive in the Soviet Union for seventy years and in Eastern Europe for forty years, only because there was a socialist system in power throughout the entire region. Private property scarcely existed, the market mechanism was all but excluded, and the socialist world was cut off from its capitalist counterpart. The situation is very different now. How can the Fidesz regime coexist with the clear fact that the centralizing tendency has strengthened, but there is no socialist system surrounding it? How can the system of state commands coincide with the capitalist economy?

'Coexistence' that undermines trust

There is no sign of the Orbán regime preparing for mass nationalization or collectivization – not even its angriest critics would suspect that. The regime has accepted that private ownership is Hungary's dominant form. (Even so, its significance is not emphasized in the new constitution and the state's acknowledged obligation to protect it has been left out. Indeed the expression 'private ownership' does not appear anywhere – perhaps a Freudian omission.)

There is no capitalist country in the world where a centralized state and a decentralized market do not coexist in some form; nor does the latter operate in an uncontrolled manner, as so-called neo-liberals are alleged to demand. (In fact, no sane economist has ever described anything of the kind.) The state everywhere exerts some supervision over the economy, intervenes in the economy to some extent, provides some free services, performs a measure of redistribution and influences demand through its procurements. Everywhere there are frictions, indeed conflicts in the coexistence of state and market, around the points of contact between them. The worldwide financial crisis has brought to the surface some dangerous phenomena. For instance, some developed countries that went too far in deregulating their financial sectors are now re-imposing regulation and making their systems more effective.

Coexistence between the state and the capitalist market economy is in an at least tolerable condition in most countries. In fact, the relation is positively fruitful in some, despite a certain degree of friction. On the one hand, state intervention cushions the market's failures and makes income distribution fairer. On the other, the market flexibly and effectively corrects the government's mistakes. However, these fortunate cases do not refute the general observation that state and market are two different kinds of organism alien to each other: their coexistence is not easy.

It is a mistake to think the various elements of state activity and the various elements of market activity can be combined in any desired proportion. The governmental measures of the last twenty months have whimsically alternated between elements of socialism and capitalism, centralization and decentralization, and state and market activity. Parliament has hastily adopted more than one proposal in which one measure has a 'socialist' feel to it and the next a 'capitalist' one. The resulting system is no unique 'Hungarian model' of which we can be proud, or to which we can draw the attention of a benighted world. The socio-economic structure under which we are living is incoherent and replete with inconsistencies. Nor has it sought to reconcile the advantageous traits of socialism and capitalism; it assumes in the main the least attractive traits of both.

In the light of these facts, let us look at the individual features of the processes that have taken place over the last twenty months. Strong words are used against bankers, speculators and adventurers – formulae borrowed from the current worldwide wave of antipathy towards capitalism – mainly when a wider domestic public is being addressed. The twilight of the West is nigh. Yet there have been cases where the head of government or a minister meeting with Hungarian and foreign business people, investors or leading bankers has addressed them in objective tones. If we only had words to go by, it would be hard to say whether the regime was a friend or an enemy of capitalism.

Words might be tolerated, but there have also been deeds unacceptable to sincere believers in the capitalist system. It has been cited a hundred times, but it remains the gravest iniquity in this respect, that the government confiscated the private savings that had built up in the pensions funds. The defenceless citizens sought protection and a remedy for their grievances from the Constitutional Court, but it let them down. That grave injury cannot be healed; this above all has undermined citizens' trust in the legislature, executive and judiciary, from which they had expected protection of their property, not an attack upon it.

There has luckily not been mass nationalization, but a slow, surreptitious expansion of the state sector is nevertheless occurring. The first episode, small but alarming, occurred in Pécs, when a new Fidesz mayor, still in the time of the last government, used his security men to chase out the staff of the French-owned waterworks and took charge of it. Later, by legal means, but for economically nonsensical reasons, the government repurchased most of the shares of the oil giant MOL, i. e. it began to play the stock market, in this case sustaining an inordinate loss. It later obtained ownership rights of the vehicle company Rába. Economists remain puzzled as to the possible reasons for these moves.

It is well known that legally, economically and ethically dubious transactions took place in all the post-socialist countries during the huge process of privatization that followed the change of system. If it should emerge only now that some deal or other was illegal, an investigation might still be launched. However, confidence in the sanctity of private property will be seriously shaken if a wave of *generalized* suspicion begins, two decades after the change of system, and if there is a full, methodical criminal investigation of the whole privatization process. What is the purpose of this upheaval in property rights? 'Shake in your shoes, we're after you all'. Is that the kind of anxiety the government wants to spread in everyone who has acquired property in the last twenty years?

It is incompatible with the smooth working of the capitalist system for the state as buyer (the biggest buyer, excessively big, many say) to discriminate among potential sellers, not over business conditions, but on political grounds and in view of personal connections. There are generally known to be firms 'close to Fidesz' (just as there were those 'close to the Socialist Party' or 'close to the Alliance of Free Democrats'). Sometimes the discrimination can be detected even in the legislation, as with the exemption from 'crisis taxes' given to some domestically-owned chains of stores. The bias which exists, but is harder to detect, is that in adjudicating between tenders for state procurement orders. Furthermore, investigative journalists report the existence of 'shadow empires' in the economic background of Fidesz, receiving assistance from the political sphere and giving aid to politicians in return.

One foundation of the capitalist economic system is the respect of private contract. The government, parliament and the courts have an obligation to enforce contracts. But how can respect for private contracts be expected if the government itself, as a partner in many important agreements, sets such a bad example? When the 'crisis taxes' began to be levied, government promise after promise was heard during the negotiations, only to be broken at the next stage of talks. The banks are being trifled with; a kind of three-card trick is being played on them.

Even after tempers cool and the government side announces that this was the final move, the game resumes. This happened in several stages with the ostensibly ‘final settlement’ for individuals who had taken out bank loans in foreign currency.

The question of loans raised in foreign currency is hideously complicated and cannot be reviewed in this article, which will focus on just one aspect of it. To shed light on my contention, it is necessary to analyse only two pure cases, although in practice a broad range of cases exists that exhibit mixed features of the two extremes. One pure case is where a household was compelled to take out such a loan to improve its housing conditions: its members were not well enough informed to see their way through the web of conditions surrounding the loan. They have been trying to repay it, but they cannot, because their finances have deteriorated, for instance because the main wage-earner has lost his job. In such a case, the principle of solidarity warrants society giving assistance to the family.

The other pure case is where a borrower was hoping to make a profit out of buying a piece of real estate. S/he knew that raising a loan in any currency involved a risk. It is unacceptable to brand such a person as a ‘speculator’, for such transactions are part of the normal course of a capitalist market economy; the housing sector would never develop without them. If the transaction pays well, the borrower pockets the profit. If it does not, that is the borrower’s problem. No pity is due and still less is s/he entitled to retrospective help of some kind. Yet the final version of the ‘final settlement’ has assisted just such cases of business investment. The state has forced banks to amend earlier private contracts retroactively, at their own expense, to the benefit of the borrowers. This procedure, and similar retroactive contract amendments made under state pressure, have caused perilous legal uncertainties. This is a classic example of what I termed in my earlier work as a ‘soft budget constraint’. If there are mass bail-outs of profit-greedy individuals now in financial trouble, entrepreneurs, investors, local government organizations or ordinary citizens will be led to think that they do not need to hesitate about taking risks. They can safely take out loans for as much as they wish, because they will be bailed out if they get into trouble. Even if they signed a contract, what does a little signature matter?

Respect for private contract and the security of the law was also damaged by legally inadmissible legislation that retrospectively expropriated many severance payments to employees. Owners hold sway over their firms’ affairs. They must abide by the valid laws of the state, but having done so they are sovereign decision-makers. Yet this government has repeatedly breached the basic market rules of capitalism in the past and continues to do so. Fidesz’s people announced that private firms would have to compensate employees who lost by the introduction of single-rate flat income tax. ‘Wage commandos’ are being sent out to firms to check whether this has been done. There is even an open threat attached: firms that do not meet the requirement will not qualify for state procurement orders. The authorities are meddling in what can or cannot be sold at a filling station, in how many chemist’s shops and how many tobacco outlets a town may have. The state is intervening with the force of law in whether shopping malls may be built.

‘Profit’ is a word with a pejorative ring for Marxist propagandists, but those who have studied economics know that profit and investment are closely tied on the macro level. On the micro level, most firms (including banks) cover a large part of their capital investments out of their own profits. Only part of those profits reach the owners as money that they are free to spend. If they want they can use profit-based funds for consumption or for personal capital investment. However, by clamping down on corporate profits, the state will deal a heavy blow to the investment process. Loss-making firms will try to ride out the storm for a time, usually by trimming back their activities, and many of them become insolvent sooner or later. Brutally high ‘crisis taxes’ cannot qualify as praiseworthy ‘unorthodox’ methods of relieving citizens that do credit to the administration’s ingenuity. When the profit motive for firms and banks is seriously imperilled, the ultimate hope of finding funds for lasting growth is lessened. It is useless for propagandists to proclaim that the government’s main aim is to produce growth, if its deeds drastically reduce the possibility of investment funded out of profits.

Against such a backdrop the peaceful coexistence between state and market becomes almost impossible. The government seeks to bring the private economy under its sway, and notably its life-blood, the financial sector. The centralized state pyramid sees itself as all-powerful and tries to dictate through its available means, while the decentralized market around it is incapable of collective action to defend itself by similar means. Yet it too reacts, as explained in the next section.

Arbitrary state action and market reactions

One of the important features of capitalism is that it consists of millions or tens of millions of atomized players, each rivalling each other, often in greater or lesser conflicts with each other. This Marx saw pejoratively as the 'anarchy' of the market, as ungoverned administration, and that is what it is.

The market has its own parlance and sign-language, which has been well explored by science. Some information consists of price indicators, other of quantitative indicators of production, investment and capital flows. Let us look briefly at a few market indicators. A sizeable proportion of Hungary's state debt consists of state bonds. When an issue of bonds matures, the state must pay it back with interest (its yield, in business parlance). Then new bonds must be issued to cover the repayment. If a state cannot make the repayment it becomes insolvent, the state goes bust and the investors' money is lost. Thus buying Hungarian bonds entails a risk. What do the buyers of Hungarian state bonds think of that risk? It is superfluous to ask them in words. The answer appears in various indicators, of which two will be taken as examples here.

One is the risk premium. Investors can insure themselves against the risk of default: the bigger the risk of trouble, the higher the premium. The country risk premium for Hungarian state bonds has been climbing. Before the Fidesz government took power, in May 2010, it was around 250 basis points. In October it rose above 550 basis points on several occasions. In January 2012 it exceeded 700 basis points. Another significant indicator concerns the yield on ten-year state bonds. Before the 2010 elections the expectation was 6–7 percent per annum. These days investors are only prepared to buy such bonds if the Hungarian state offers an annual rate of interest of 9–10 percent. This is an unprecedented cost. It is unpayable by any economy presently stagnating or possibly shrinking, with a prospect of growth one day, but likely to be slow for some time. If Hungary's financial policymakers accept it by floating more bonds, the country will find itself in a debt spiral, or worse still, in an accelerating whirlwind of debt.

It is unclear to the government, judging by official statements, that the investment experts at home and abroad are not usually 'speculating' with their own money. Most are handling the money of insurance institutions, pension funds, and investment banks that marshal the savings of private individuals. They attend to the views and advice of analysts and credit-rating institutions. Some investors – to safeguard their depositors, insurance clients and pension beneficiaries – are *obliged* to refrain from investing in junk bonds. It is a waste of breath to engage in polemics with them or with analysts or credit-rating agencies. Even if they err occasionally, what they do and decide is an economic *reality*.

There is a strong economic correlation between market movements for sovereign paper and exchange rates. Foreigners who sell bonds bought for forints hasten to exchange those forints into euros or dollars or another currency. Amidst the sharp fluctuations, the trend is clear: the forint has weakened perceptibly against all other currencies. Albert Hirschman, in his splendid book *Exit, Voice and Loyalty,* stressed a wonderful thing about the market: there is no need to say anything, no need to protest or threaten or shout. It is enough to exit. When the centre handling Hungary's state debt announces an auction of new state paper and no buyers appear (as has happened several times), it shows that investors who would have gladly bought Hungarian state bonds earlier have silently left. Government spokesmen are scaring citizens by saying they will detect who is giving the forint a bad name and punish the rumour-mongers, but that will not stop the flow of deposits from Hungarian banks into foreign ones, which is reducing the funds available for real investments in Hungary.

Still clearer signals of exit are emitted by the figures for the decline in lending and in the propensity to invest. The threat here is not just to the financing of Hungary's budget deficit – the *short-term* financial balance – but to the country' *long-term* prospects of growth. There are many factors affecting the supply of credit. The mounting tax burden on the banking sector is certainly one contributor. The fall in lending to firms is conspicuous.

For a long time, one driving force behind growth in the Hungarian economy was the inflow of operating capital (foreign direct investment). This moved for many years within a band of an annual 3–10 percent of GDP. There is no figure available yet for the whole of 2011, but the figure for the first three quarters was saddening: for the first time foreign direct investment was negative, in other words more capital was taken out of the country than brought in. This was an alarming signal indeed of silent withdrawal. Another important figure: investment in the competitive

sphere stagnated. The volume in the first three quarters of 2011 was equal to the same period of the previous year.

The chain of cause and effect, impulse and reaction, is clear. The confidence of the business world has been undermined by the whimsicality and unpredictability of Hungarian economic policy, legal uncertainty, and repeated breaches of the rules of a capitalist market economy – including more than one grave and crude breach of fundamental principles. The destruction of trust leads to a worsening of the financial conditions for normal operation of the Hungarian economy, thus damaging the prospects for long-term, lasting growth.

This brings me to my final conclusion. The Orbán regime has attained its real goal: it has harshly seized power; by strengthening centralization and extending the power of the state it has gained the means of exerting unlimited power. However, autocratic rule, unbridled centralization and excessive expansion of state activity are incompatible with healthy running of a modern capitalist market economy. Following *this* road, it will be impossible to raise the Hungarian economy out of stagnation and onto a path of sustainable growth; and Hungary's present and future generations will suffer as a result.

The EU Mechanical Engineering – Success in Global Markets Drives Growth

Hans-Günther Vieweg*

Mechanical engineering has been acknowledged by European policy makers as a crucial pebble in the mosaic of competitiveness. Numerous studies have been commissioned by the European Commission and member states' governments. One of the more recent studies, the EnginEurope report was concluded just before the financial crisis shattered the global economy. The latest project, the *Study on the Competitiveness of the EU Mechanical Engineering Industry* (henceforth ME), which was also commissioned by the European Commission, was led by the Munich-based Ifo Institute.[1] Cambridge Econometrics and the Dansk Technological Institute were also members of the project team. The study was carried out in the context of the framework contract on Sectoral Competitiveness Studies (ENTR/06/054) over the time period of 2007 to 2011. This study aimed to contribute to the initiatives of the European Commission to strengthen the performance of the EU ME in international competition. This is in line with the Commission Communication of 3 March 2010 on objectives to be reached by 2020[2] and the 'Communication on a New Industrial Policy' – published in October 2010 – as a guideline for policy options and recommendations.

The strong performance of the EU ME was primarily driven by its unique product programme that meets the needs of globalization. The access of EU manufacturers to large and high-growth emerging markets has stimulated growth and contained the negative effects of the financial and state debt crisis, in spite of some weaknesses in price competitiveness. The long-term prospects are bright, although cyclical fluctuations in demand will remain a challenge to firms. Temporary setbacks should not affect the long-term confidence in the competitiveness of the EU ME. The companies should strive for opportunities in overseas markets. This calls for a strengthening of their foothold in these markets *via* foreign direct investment. Companies also need to factor the requirements of overseas clients into innovation in goods and services.

Comparative advantages of EU mechanical engineering

ME as one the EU's major branches

ME is one of the major branches of manufacturing in the EU27, with a share of around 9.1 percent of all production in manufacturing industries. Compared to other industries, ME firms are characterized by a relatively high manufacturing depth. This is mainly due to three factors: predominant small-batch and single-item production, high qualification requirements in manufacturing departments, and the need for close communication between manufacturing, engineering and design departments. As a result, the share of ME's value added of total manufacturing is higher than that of production, reaching around 11.5 percent. The higher share of value added is also reflected in employment, which also accounts for a similar share of total manufacturing (Table 1).

EU ME's growth in productivity is, on average, much higher than that of total EU manufacturing. Only during the financial crisis, when ME was hit harder than other industries, did productivity break down. This is a typical cyclical pattern inherent to the nature of this industry, and output growth was below productivity growth for most of the period under consideration. For ME, as well as for total manufacturing, output growth was not sufficient to prevent job losses.

* Ifo Institute. This article has been produced using the content of the Study on the Competitiveness of the EU Mechanical Engineering Industry with the permission of the European Commission. The views expressed here are those of the author and do not necessarily reflect the opinion of the European Commission.
[1] This study can be found at http://ec.europa.eu/enterprise/sectors/mechanical/files/competitiveness/comp-mech-eng-2012-frep_en.pdf.
[2] European Commission (2010), *Europe 2020 – A European Strategy for Smart, Sustainable and Inclusive Growth,* Brussels, 3 March.

Table 1

Key figures for EU27 in mechanical engineering

Sector	Indicator	2010		Annual average growth rate in % 1995–00	2000–05	2005–08	2008–10
Manufacturing	Production, in current prices	bn €	5,885	5.3	2.1	6.7	– 5.2
ME[1]			502	4.0	2.3	10.4	– 8.4
Manufacturing	Gross value added, in 2010 prices	bn €	1,504.0	2.1	0.0	1.5	– 5.2
ME[1]			157.5	2.4	0.3	6.0	– 9.3
Manufacturing	Employees	1,000	30,063	– 0.6	– 1.3	– 0.3	– 4.8
ME[1]			2,901	– 1.6	– 2.2	1.8	– 4.8
Manufacturing	Productivity[2]	1,000 €	50.0	2.7	1.3	1.8	– 0.4
ME[1]			54.3	4.0	2.6	4.1	– 4.7

[1] ME = mechanical engineering. [2] Value added per capita and annum at 2010 prices.

Sources: Eurostat; Cambridge Econometrics; Ifo Institute.

ME is vital for the EU's current account balance

The EU ME is not only one of the most important providers of jobs within the EU, but also contributes significantly to a sound current account balance of the EU27. In foreign trade with manufactured goods the EU shows a noteworthy deficit. In 2010 extra-EU exports only amounted to 1,343.9 billion euros, whereas imports reached 1,500.6 billion euros. For ME however, exports amounted to 200.4 billion euros, with imports of 81.2 billion euros. In 2010 the trade deficit for total manufactured goods had reached 156.7 billion euros. Without the surplus created by ME, it would have been more than three quarters higher and would have reached 275.9 billion euros. Over the period under consideration, the EU ME's trade surplus nearly tripled and more than compensated for the growing deficits in trade with manufactured goods. ME has become more important for the EU27's current account balance.

A global heavyweight among major competing economies

The most important competing economies for the EU ME are Japan, China and the United States. The EU ME is by far the largest industry as compared to the United States and Japan, which only accounted for

Table 2

Key figures on the economic performance of major competing economies in mechanical engineering

2010[1]			EU27	USA	% EU	Japan	% EU	China	% EU
Output [2]	Current prices	bn €	502.1	221.6	44.1	151.9	30.3	480.6	95.7
Value added	Constant prices	bn €	157.5	103.0	65.4	66.2	42.0	161.4	102.5
Employees	Numbers	1,000	2,900.5	1,130	39.0	684.6	23.6	6,113	210.8
Labour productivity	Value added per employee[3]	€	54,290	91,125	167.8	96,700	178.1	26,399	48.6
Labour costs	Per employee	€	33,243	39,815	119.8	32,420	97.5	3,700	11.1
Gross operating	Share of value added	%	38.8	56.3	145.2	66.5	171.5	86.0	221.8
Unit-labour costs[5]	Labour costs per output unit	€/€	0.61	0.44	71.4	0.34	54.8	0.14	22.9

[1] 2010 prices and exchange rates; [2] Turnover /production; [3] At constant prices; [4] (Value added-wages)/value added); 5) value added at constant prices per 1 € labour costs.

Sources: Eurostat; National Statistical Offices; Cambridge Econometrics; Ifo Institute.

65.4 percent and 42.0 percent respectively of the EU ME's value added in 2010. However, the Chinese ME has caught up rapidly over the past decade and – as measured by value added – is now on a par with the EU (Table 2).

Between 2000 and 2010 the ME's outputs in the United States, Japan, and the EU changed at annual average rates of – 1.1 percent, – 3.3 percent, and 1.0 percent respectively. To a certain extent, the industry's relatively favourable development in the EU is caused by stimulating domestic demand. However, trade analysis reveals that the EU also performed better in international trade.

ME employment development has been better than that of manufacturing as a whole

Over the period 2000–2010, overall employment for the ME declined by 2.6 percent in the United States, 3.3 percent in Japan, and 1.5 percent in the EU. This development cannot be attributed entirely to the global economic crisis and the slump in 2009. In fact, employment only grew in the period 2005 up to 2008 in the United States and the EU. EU ME employment development has been better than for manufacturing overall, despite the fact that ME was hit harder by the crisis than most other EU-industries.

The Chinese ME has enjoyed breath-taking growth over the past decade. By 2010 total output had reached 480.6 billion euros. As measured by the value added, the Chinese ME had already overtaken the EU in 2010, amounting to 102.2 percent of the EU's output level. Between 2000 and 2010 the workforce grew by an annual average rate of 5.8 percent by up to 6.1 million employees, which is more than double the EU figure.

Poor performance in price competitiveness is a burden

The EU ME-industry faces a major productivity challenge

An investigation into the performance of the major competing economies in ME revealed major differences in performance (labour productivity defined as value added per employee), which can be taken as an indication for price competitiveness. Japan is in the lead in terms of labour productivity, closely followed by the United States. Third in this ranking is the EU27, but at a much lower level. This could be caused by heterogeneity within the EU, which includes member states with substandard economic performance. However, intra-EU regional differentiation discloses that none of the member states comes close to the United States or Japan. For the EU countries under investigation, Germany shows the highest labour productivity at a level of around 70,000 euros, still over 20 percent below the US ME's labour productivity (Table 2).

Like labour productivity, wages vary among competing economies. The US ME is in the lead, with wages per employee that are around 20 percent above the EU average. Despite its much higher labour productivity, Japan's wages are close to those of the EU. China lags far behind, with wages of 11 percent of the EU average.

The economic performance and profitability of the ME industries under investigation was assessed using the gross-operating rate (GOR) and unit-labour costs (ULC). The EU is lagging behind its competitors in terms of the GOR – the share of value added that remains to pay for other input factors and profits once labour costs have been deduced. The GORs for the United States and Japan exceed those of the EU by 45 percent and 72 percent respectively. The Chinese GOR is more than double as high. For the ULC the picture is quite similar.

The major reason for the EU ME's poor performance in indicators for price competitiveness lies in its high wages compared to its low labour productivity. This result is widely-known and not limited to ME. For many years it has raised concerns and led to initiatives taken by the European Commission, as well as national governments, aimed at catching up with the United States in terms of productivity.

Resilience during the crisis has improved the EU's ME relative position

The analysis of its economic performance has disclosed that the EU ME's labour productivity grew more strongly over the period under investigation than that of the United States, while Japanese labour productivity declined. For the whole period under investigation, EU ME's labour productivity grew at an average yearly rate of 1.5 percent, whereas the United States reached just 0.8 percent. The EU lead stems from a less dramatic breakdown during the global crisis in 2009. For the period 2000 and 2008 the United States was leading development at an annual

Table 3

Changes in the mechanical engineering industry's price competitiveness

Sector	Indicator	2010[1]		Annual average change rate in %		
				2000–05	2005–08	2008–10
EU27						
Labour productivity	Value added per capita[2]	€	54,290	2.6	4.1	– 4.7
Labour costs	Per employee	€	33,243	3.1	3.7	1.9
Gross operating rate[3]	Share of value added	%	38.8%	– 0.6	0.5	– 8.6
Unit-labour costs[4]	Labour costs per output unit	€ / €	0.61	0.5	– 0.5	6.9
USA						
Labour productivity	Value added per capita[2]	€	91,125	5.5	0.3	– 9.3
Labour costs	Per employee	€	39,815	3.7	1.8	– 8.5
Gross operating rate[3]	Share of value added	%	56.3%	1.4	0.1	0.6
Unit-labour costs[4]	Labour costs per output unit	€ / €	0.44	– 1.7	1.5	0.9
Japan						
Labour productivity	Value added per capita[2]	€	96,700	1.7	1.6	– 6.0
Labour costs	Per employee	€	32,420	0.5	– 2.4	– 3.0
Gross operating rate[3]	Share of value added	%	66.5%	0.1	2.1	– 1.5
Unit-labour costs[4]	Labour costs per output unit	€ / €	0.34	– 1.2	– 3.9	3.1
China						
Labour productivity	Value added per capita[2]	€	26,399	10.2	19.0	9.2
Labour costs	Per employee	€	3,700	16.1	17.6	11.6
Gross operating rate[3]	Share of value added	%	86.0%	– 0.7	0.2	– 0.4
Unit-labour costs[4]	Labour costs per output unit	€ / €	0.14	5.3	– 1.2	2.3

[1] 2010 prices and exchange rates; [2] At constant prices; [3] (Value added – wages)/value added; [4] Value added at constant prices per 1 € labour costs.

Sources: Eurostat; National Statistical Offices; Cambridge Econometrics; Ifo Institute.

rate of 3.5 percent, whereas the EU ME's labour productivity increased by 3.2 percent yearly (Table 3).

Rising labour costs put EU ME's gross operating rates under pressure

Nevertheless, wages in the EU ME grew between 2000 and 2010 at an annual rate of 3.0 percent, a much higher rate than that of the US ME at 0.6 percent. The gap was caused by different labour market regimes and collective wage contract agreements. Until 2008, wage increases in both regions followed a similar pace. During the crisis, US wages per capita fell, whereas EU wages did not stop growing. The EU ME's price competitiveness worsened dramatically and did not fully recover until mid-2011, while Japan's price competitiveness was improved only by shrinking wages per capita. Rigid labour market regulation is considered a threat to industries in a volatile market environment such as ME.

New member states will face growing competition from China

Chinese ME's labour productivity grew in the period 2000–2010 at an average rate of over 10 percent per annum, reaching around half of the EU27's level. Current Chinese labour productivity levels are comparable to those in Poland, the Czech Republic and Slovakia, whereas labour costs in these new member states are much higher. This gives Chinese enterprises an edge and challenges these (new) member states that

are more focused on production than on R&D, design and marketing. They will therefore experience growing competition from China.

Impressive performance in international trade

EU ME exports amount to 15 percent of all exports from manufactured goods

As already mentioned, EU ME contributes to a noteworthy surplus in foreign trade, thereby reducing the large deficit in trade with all other manufactured goods. The extra-EU exports of ME amounted to 200.4 billion euros in 2010. This accounts for around 15 percent of total manufactured goods, a much higher share than ME's weight of total manufacturing's output. This underscores the EU ME's strong dependency on global markets. The EU ME's exports grew at an annual average rate of 5.8 percent between 2000 and 2010, whereas the exports of non-ME goods only increased at a rate of 5.2 percent.

US and Japanese shares in global trade have fallen drastically

The EU's share in global trade with ME products amounted to 37.2 percent in 2010, corresponding to 539.0 billion euros, which was roughly 3 percent above its share in 2000. Compared with major competing economies, the EU ME has performed very well. This development contrasts with the performance of the United States and Japan, which both lost global trade shares. The US share fell from 25.6 to 17.4 percent and the Japanese share fell from 21.3 percent to 15.6 percent. Over the period under investigation China was the outstanding winner. Its share in global trade was only 3 percent in 2000, but had soared to 13.0 percent by 2010. The comparison of the EU with its most important competing nations underscores the strength of its ME enterprises – well-established suppliers in the global market – that have successfully expanded their trade shares despite the fact that emerging competitors have tapped into the market.

Developed industrial nations can keep up comparative advantage in ME

Although the United States and Japan have lost shares in global trade with ME products, ME has remained of outstanding importance in limiting the EU's deficit in foreign trade with non-ME products. Analysis in foreign trade shows that both the United States and Japan command comparative advantages in ME by specializing in ME products. It is noteworthy that the United States, a country leading in ICT

Table 4

EU machinery trade with major competing economies' important sales markets

Destination	Mechanical engineering EU exports to …			Total manufacturing EU exports to …		
	bn €	Share[1)]	Perfor-mance[2)]	bn €	Share[1)]	Perfor-mance[2)]
Major competing economies						
USA	27.3	34.2	+	240.3	16.8	–
Japan	4.2	22.0	+	43.8	8.5	–
China	28.0	37.2	+	75.3	10.9	=
Major sales markets						
MENA	17.7	69.2	–	111.9	43.2	–
Russia	14.1	92.7	=	86.3	53.7	=
Turkey	8.1	76.6	+	61.1	43.8	–
South Korea	7.6	41.5	+	27.9	10.3	=
India	7.0	57.3	–	34.8	12.9	–
Brazil	6.9	50.0	+	31.1	22.9	–
Taiwan	4.2	37.4	+	14.7	19.0	+
Australia	4.2	31.9	=	26.7	19.3	=
Canada	3.7	15.2	+	26.5	9.1	=
Mexico	3.6	20.0	+	21.4	9.6	=
Indonesia	1.6	15.0	–	6.4	6.2	–

[1)] Of the destination country's imports in %. [2)] For the period 2000 to 2010 the EU's import share was growing (+), about stable (=), declining (–).

Sources: Eurostat; National Statistical Offices; Cambridge Econometrics; Ifo Institute.

technologies, boasts comparative advantages in related ME products. By the same token, Japan, a leading economy in both ICT technology and the automotive industry, also shows comparative advantages in such ME products. This finding supports the assumption that ME is an industry with comparative advantages for developed industrial nations, even in the era of globalization. Indeed, the strong international performance of ME enterprises has turned out to be an asset for the EU in the globalized economy.

At the cutting edge of technology

EU ahead of US and Japan in terms of research intensity

ME is one of the core EU industries, not only in terms of its size, but also in terms of its performance in international technological competition. The 'innovation intensity', as measured by innovation expenditure as a share of total sales, shows the EU ME's strong position compared with major competing economies in two respects: the EU ME's innovation intensity is higher than that of its US and Japanese competitors. Moreover, the EU ME's innovation intensity is higher than the average value for of all EU industries. For Japan and the United States the comparison of ME with their national industries discloses a below average innovation intensity. This is a clear indication of the EU ME's comparative advantage in international competition and its lead in terms of R&D.

The EU ME is particularly strong in mechanical technologies and material sciences

The EU ME commands an outstanding position in international technology competition, particularly in mechanical technologies. This position is less outstanding in some advanced technologies supplied by upstream industries, above all in electronics and optoelectronic components, an area in which the EU had to struggle to catch up to the state-of-the-art technology in the United States and Japan. Although the EU has caught up, a certain dependency on deliveries remains, particularly from Japan.

In material sciences the EU is a global leader, be it in nano-technologies, carbon-fibre-reinforced polymer (CFRP) etc. In CFRP, the EU commands a strong global position. This can be attributed to know-how in different technologies and the ability of EU companies to co-operate in multidisciplinary projects. In particular, the EU strength in manufacturing technologies provided by ME, for instance by manufacturers of textile machinery, gives the EU an edge over competitors from Japan and the United States. A widespread dissemination of CFRP applications beyond aerospace will be strongly dependent on process innovation towards greater automation.

ME as an enabler for a range of other sectors

ME boosts resource efficiency across economic sectors

The supply of ME is not only of importance for all manufacturing industries, but also for agriculture, mining, construction and even the service sector. ME has been characterized as 'the enabling industry'. This means that it supplies machinery and equipment, as well as process know-how, to all its client industries, enabling them to produce their goods and services with an optimized use of input factors of an extraordinary quality. For some time policy makers placed great emphasis on resource efficiency to reduce the impact of economic activity on the environment. Resource efficiency has always been a focus of ME. Over the past decade ME companies' permanent product and process innovations contributed much to CO_2 emission avoidance by their clients investing in the latest available technology. This know-how will become an even more persuasive factor in making purchasing decisions when natural resources become even scarcer.

ME-firms become full-value suppliers

One of the long-term tendencies of ME enterprises has been their specialization in certain market segments and their focus on clients with specific needs. Simultaneously, ME firms strive for an expansion of their product programmes to become full-value suppliers, i.e. to offer all the products and services a client could ask for. This has increased the importance of system engineering and provided a broader focus on product, as well as process innovation. The integration of diverse technologies and the co-operation of technicians from different disciplines have been perceived as strengths of the EU ME. These abilities are well-suited to give EU companies an edge in view of global competition and growing price pressure.

Beyond system engineering, a range of pre- and after-sales-services are offered by ME enterprises. Most of these services are technical, closely related to physical

products delivered to clients. Other services offered to clients go far beyond the technological competency of ME firms, such as the financing of clients' purchases, the operation of plants and production sites for clients, contracting etc. These services create new business opportunities for ME firms. Even though these services do not present a noteworthy share of total supply in some ME market segments, they have been offered successfully and have become relevant for the design of new business models. On average, for total ME, the share of services lies between 10 percent and 15 percent. Surveys carried out by industry stakeholders show that services have been growing stronger than the output of physical products.

This development into full-value providers has certain implications for the performance of the EU ME. Firstly, the comparative advantages of the EU ME with its qualified staff experienced in cross-disciplinary cooperation and its knowledge of process technology is a unique feature that differentiates the EU ME's supply from that of competing emerging economies. Secondly, these services present additional value added and create new workplaces for highly qualified staff. These services are well-suited to compensate to a certain extent for relocation-driven losses of low-value added production. Thirdly, even totally new business areas can be accessed such as Build-Own-Transfer (BOT) and contracting. Fourthly, these new business areas are less dependent on highly volatile investment cycles, therefore reducing the cyclicality of ME's business activity.

Structural changes and value chains

Strong ties with upstream and downstream industries have both pros and cons

ME is not only characterized by an intra-industrial, but also by an inter-industrial division of labour. Upstream linkages to metal industries, electrical engineering, the electronics industry etc. call for a good industrial infrastructure as a prerequisite for a competitive ME. It is a less 'mobile' industry than, for instance ICT, with its longstanding tradition of global production networks for the exploitation of low-wage supply. ME has always exploited the advantages of the broad industrial infrastructure in Europe. This has not changed even though global networks have been created to build on comparative advantages in other regions and to improve access to remote markets.

Likewise, downstream linkages are also important to the competitiveness of ME. Close ties to client industries and their specific needs have help to turn the EU ME into a global leader in manufacturing technologies. However, loss of capacity, such as in the production of textiles and clothes in Europe, has also led to a loss in related global dominance and technology and production for the ME manufacturers concerned.

Since the late 1980s ME has evolved from less integrated national industries towards a pan-European ME industry. The transition and economic integration of the new member states economies has largely been concluded. However, the integration of the EU ME and its cohesion has been challenged by volatile macroeconomic developments in certain (southern) member states over the past decade. The financial and subsequent public finance crises have brought the problems to light. The ME industries of the member states concerned have suffered losses of competitiveness.

EU ME industry has undergone consolidation

ME is an industry characterised by smaller family owned companies that typically have between 500 and 2,000 employees. Most of them do not fall under the EU definition of a SME (up to 200 employees). Recent decades have seen consolidation in the EU ME. Companies have merged or been taken over by others. Medium-sized groups have been created that exist alongside the typical medium-sized, family held and independent companies. These groups' advantages lie in the combination of smaller firms' flexibility with larger firms' potential to access global sales markets and to carry out larger research projects. Moreover, they can allocate the necessary resources to shoulder the increasing administrative burden created by requests from clients and growing regulation. This development has strengthened the competitiveness of the EU ME in an era of globalization and larger markets.

The free circulation of products in the EU single market has tightened competitive pressure on smaller manufacturing firms that specialize in niche markets. Market shares are being taken over by larger competitors that try to fully exploit their growth potential within the EU. In some of these market segments the very small industrial enterprises will have to put their business models to the test and decide if they can continue to run their own manufacturing facilities. Better

opportunities could be provided in the handicraft market, where services such as the installation, maintenance and repair of machinery require regional proximity to clients, as for instance in the market for heating, ventilation and air conditioning.

The value chains within the EU ME have been adjusted to reflect the opportunities provided by globalization. Suppliers within a value chain feel growing competition in bidding processes from non-EU competitors. A growing number of clients are asking for a price/performance-ratio based on international tender procedures. If suppliers cannot meet these requirements, they have to relocate or to quit their role in a value chain. There are examples of clients supporting their suppliers' decision to relocate or following suit to overseas locations. Such initiatives can be of mutual interest and strengthen the EU ME.

In some areas, there is a trend towards client companies focusing their business activities on system integration. This provides opportunities for suppliers to become subsystem manufacturers and integrators. Companies that can allocate the necessary technological and financial resources will benefit from this development if they can build on sufficient management know-how. These companies are less exposed to international price competition than those with a lack of resources.

Asian production sites can help the EU ME industry to remain competitive

Asia has become an important region for the EU ME. Production locations owned by EU firms and Asian manufacturers have become an integral part of the EU ME value chain. Asian deliveries primarily consist of large batch, medium-tech products, whereas in Europe small batch production and customization as a share of total output is growing. This division of labour between Asia and Europe provides European manufacturers with opportunities to remain price competitive in medium-tech serial production. They do not leave market segments that – not by margins – but by volume are of crucial strategic importance and could otherwise be used as a gateway by emerging competitors. Competitors from low-wage countries could more easily enter machinery markets and cause cut-throat competition by permanent upgrading. EU ME firms use locations in low-wage countries outside the EU to control the lower end of their product programme abroad and in the domestic market.

The on-going structural change of the EU ME in the face of increasing globalization is driven by specialization in comparative advantages. Workplaces have been lost in low-value added areas and new opportunities have been created for more qualified labour. All in all, the competitiveness of the EU ME compared to the United States and Japan can be evaluated as strong with regard to the employment record and performance in international trade. However, losses in low-wage labour have not been fully compensated for by new opportunities. In particular, production locations in the new member states are endangered by competition from Asia. The comparatively rigid labour markets and collective wage agreement systems could contribute to a less dynamic structural adjustment of the EU ME to global needs.

Prospects are bright

Economic growth potential

The ME's future growth potential is assessed on the basis of projections for the EU27, the United States, Japan and the BRIC countries by the IMF's World Economic Outlook for the medium-term and by Goldman Sachs for the long-term. The growth momentum of the BRIC countries, above all China, will cause a shift of economic activity away from Europe to Asia.

Total production by the ME of the seven analysed countries and the EU27 will grow from 527 billion euros in 2010 to 928 billion euros in 2025, equalling an annual average rate of 3.8 percent. Although all individual countries and the EU27 look able to grow, China will clearly dominate the world output of mechanical engineering products by 2025.

However, this growth scenario derives the development of the ME sector only from domestic GDP development, and does not consider the special importance of trade for this sector. For the EU27, around 40 percent of growth in ME can be accounted for by trade-induced demand. Therefore a second 'trade-adjusted' scenario is derived whereby 60 percent of the growth is generated domestically, whereas the remainder is generated by increased demand in the world market. Using this second scenario, the EU27 would be able to achieve a market size of 232 billion euros by 2025, compared to the predicted market size of 204.7 billion euros stemming from the base scenario.

Table 5
Expected development of mechanical engineering output by selected countries (trade-adjusted scenario)

	Value added in bn €[1]					
	2000	2005	2010	2015[1]	2020[3]	2025[3]
Brazil	11.0	13.2	14.2	18.8	22.6	27.2
China	28.2	58.4	161.4	248.0	329.4	410.1
India	6.3	8.4	12.8	19.3	26.0	34.4
Japan	89.7	96.2	66.2	75.4	81.0	86.3
Russia	9.8	10.8	12.1	14.9	17.6	20.8
USA	123.7	124.5	103.0	115.5	129.7	144.9
EU27	158.0	160.8	157.5	178.3	193.2	204.7
EU27 with trade				183.5	208.4	232.0

[1] 2010 prices and exchange rates. [2] Based on GDP forecasts from IMF. [3] Based on GDP forecasts from Goldman Sachs.

Source: Own calculations.

In the long run, growth rates in other BRIC countries may well exceed those of China

When looking at expected growth rates, a more diverse picture emerges. Although China is clearly leading in terms of growth rates from 2000-2015, those of other BRIC countries will reach similar, or even higher levels in the period thereafter. Japan, the United States and the EU27 are expected to have significantly lower growth rates throughout the whole period of analysis. Growth rates for the EU27 differ between the baseline scenario and the scenario including trade by around 1 percent.

Productivity development

The long-term trend in productivity development – a prerequisite for longer-term competitiveness – suggests a stable growth rate. Current developments fall into line with the long-term trend from 1995 to 2008. Average annual growth rates in productivity are 2.0 percent and 3.5 percent for manufacturing and ME respectively. As these growth rates were very stable for over a decade in the pre-crisis period, it is assumed that productivity will continue to grow at these growth rates after the recovery from the crisis.

Using these growth rates, EU27 productivity can be expected to grow significantly throughout the forecast period until 2020. Labour productivity in mechanical engineering is expected to reach 67,400 euros in 2015, up from 54,300 euros in 2010. By 2020 EU27 labour productivity has the potential to increase to 79,900 euros.[3]

[3] All productivity measures are reported in constant 2010 euro per employee.

Table 6
Projected growth rates in mechanical engineering (trade-adjusted scenario)

	Annual average growth rate in %				
	2000–05	2005–10	2010–15[1]	2015–20[1,2]	2020–25[2]
Brazil	3.8	1.4	5.8	3.8	3.7
China	15.7	22.5	9.0	5.8	4.5
India	6.0	8.7	8.7	6.1	5.7
Japan	1.4	– 7.2	2.6	1.4	1.3
Russia	1.9	2.2	4.3	3.4	3.4
USA	0.1	– 3.7	2.3	2.4	2.2
EU27	0.3	– 0.4	2.5	1.6	1.2
EU27 with trade			3.1	2.6	2.2

[1] Based on GDP forecasts from IMF. [2] Based on GDP forecasts from Goldman Sachs.

Source: Own calculations.

Employment implications

Having formed expectations about growth of the ME sector and about developments in labour productivity, it is possible through triangulation to form expectations about development in employment. Such projections are made by multiplying existing employment with growth projections of gross value added (GVA) and dividing by growth projections of productivity. As expected, GVA growth rates in the EU27 manufacturing sector are consistently below the expected increase in productivity, and declining employment is expected. Projected ME employment is expected to shrink to 2.8 million employees in 2015 and to 2.5 million employees in 2020, which represents a significant decline compared to the 2.9 million employees in 2010. Using the more optimistic EU27 growth scenario that includes trade-induced growth as a basis for calculations, reductions in employment level would be more moderate: by 2015 employment would be 2.9 million and in 2020 2.7 million people would be employed in mechanical engineering.

Success in global markets is needed to secure jobs ...

Although the mechanical engineering sector is expected to achieve consistent absolute growth in the following years, this growth is probably not strong enough to more than compensate for growth in labour productivity, leading to a net loss in employment. The evolution of EU ME must be valued against a background of expectations that domestic demand will be dampened for several years by urgent measures to overcome the public debt and private banking crisis. Without success in global markets and stimulation by growth in emerging economies, the ME's perspectives would be worse.

... and success primarily means further penetration in emerging markets

Both of these development paths highlight the importance of ME's global alignment. Strong growth can only be generated if EU companies are successful in emerging economies' markets. These countries do not only provide opportunities for growth, but also for the exploitation of scale effects, a decisive factor for companies' long-term competitiveness. The EU ME's success in foreign markets over the past decade was impressive and underscores that companies do have the products needed for the industrialization of emerging economies. They are at the cutting edge of technology and have always been market leaders in the supply of resource efficient processes. In this respect, the EU ME is not only an enabling industry in the domestic market, but also in global markets. Its success in the latter markets will be decisive and will require a strong focus on third countries' needs in products systems and services. In the trade-adjusted scenario, the prospects for the EU ME are better than for total EU27 GDP. The growth momentum for the period under consideration is higher. However, due to the wealth created by significant increases in labour productivity, some losses in the labour market cannot be avoided.

Photovoltaics: Boom of the Rising Sun

Johann Wackerbauer and
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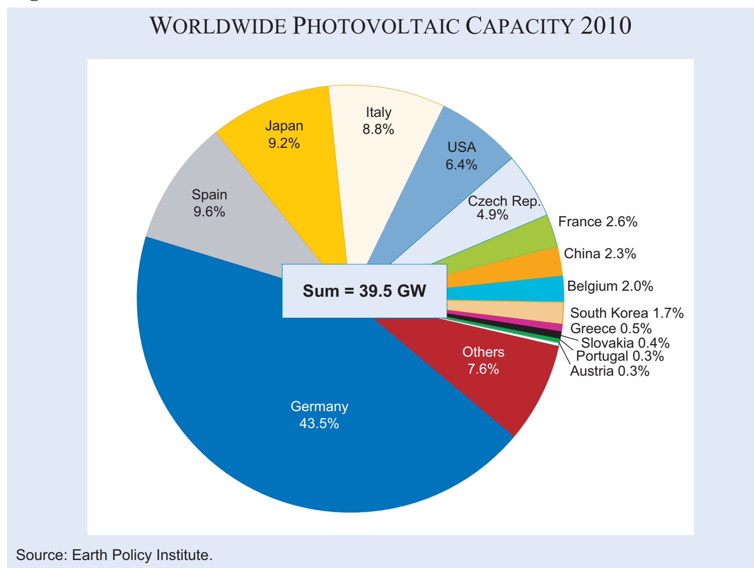
2010 was an extraordinary year for solar power. The global photovoltaic market reached a cumulative installed capacity of almost 40 GW (see EPIA 2011). This corresponds to the electrical output of 80 medium-sized coal-fired power stations. With a capacity of 17.2 GW or 43.5 percent of the global market, Germany was by far the most important location for solar power, followed by Spain (3.8 GW or 9.6 percent), Japan (3.6 GW or 9.2 percent) and Italy (3.5 GW or 8.8 percent). Photovoltaic capacity in the United States amounted to 2.5 GW (6.4 percent), while that of the Czech Republic reached 2 GW (4.9 percent) and France's capacity totalled 1 GW (2.6 percent). In China photovoltaic capacity remained fairly low and accounted for a mere 0.9 GW (2.3 percent) (see Figure 1).[1]

During the five preceding years Germany was also the leading country in new installations, accounting for 45 percent of annual added capacity of 16.6 GW in 2010. With an additional capacity of 7.4 GW, Germany's annual increase in capacity alone exceeded installations worldwide for the preceding year 2009 (7.3 GW). The second important market was Italy with new installations of 2.3 GW, three times higher than in 2009 (0.7 GW). The Czech Republic boosted its investment in solar power substantially with 1.5 GW in 2010, compared to 0.4 GW in 2009. However, Japan and the United States, which were ranked second and third in 2006 and 2007, dropped back in 2010, investing only 1 GW and 0.9 GW respectively. In France installations more than tripled to reach 0.7 GW, after starting

Figure 1

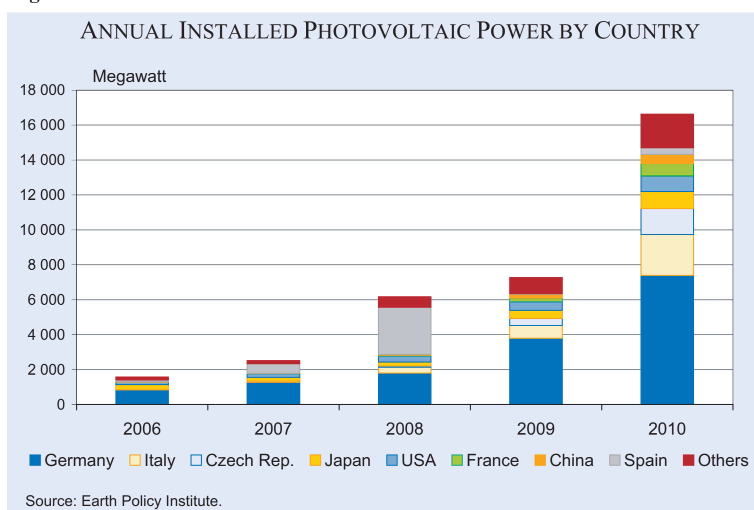
Worldwide Photovoltaic Capacity 2010



Source: Earth Policy Institute.

Figure 2

Annual Installed Photovoltaic Power by Country



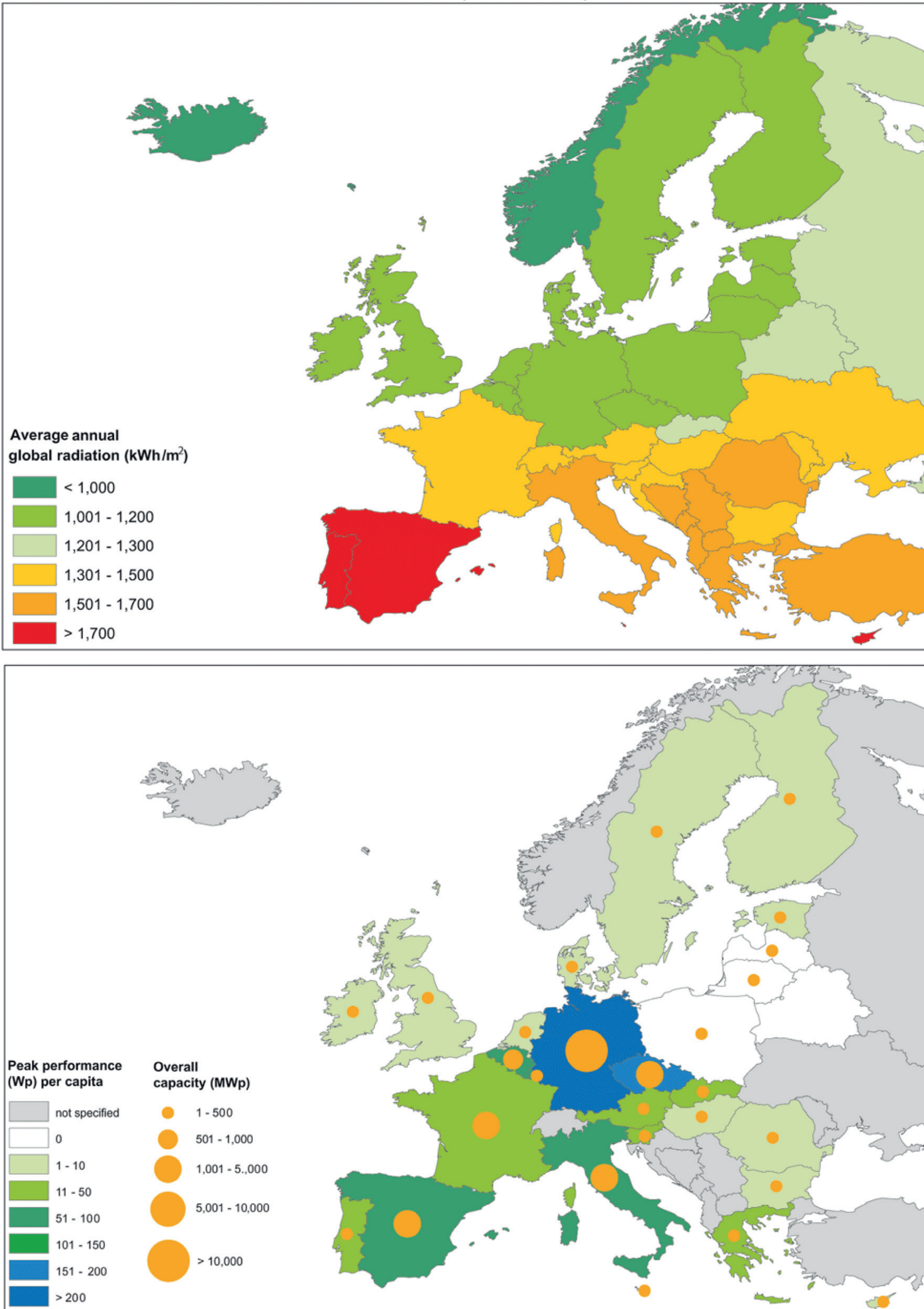
Source: Earth Policy Institute.

* Ifo Institute.

[1] In its domestic market China sets the priority on solar thermal heating. With 101.5 GW of solar thermal applications 59 percent of the world-wide capacity was located in China in 2009 compared to 19 percent in Europe (see Erneuerbare Energien 22(2), February 2012).

Figure 3

GLOBAL RADIATION AND PHOTOVOLTAIC POWER 2010



Sources: EurObserv'ER (2011); European Commission Joint Research Centre (2008).

from a low level of 0.2 GW in 2009. Spain, on the other hand, added only 0.4 GW in 2010 and saw a strong decrease in new installations compared to its 2.7 GW of 2008 (see Figure 2) after the government limited its subsidy of new installations to 0.5 GW per annum (see EPIA 2011). Overall, the European Union represented 78 percent of global new installed capacity in 2010 (see EurObserv'ER 2011).

The natural prerequisites for solar electricity production are illustrated in Figure 3 (upper map): within the European Union southern countries like Portugal and Spain are the most appropriate locations with an average annual global radiation[2] of 1,840 kWh/m² and 1,812 kWh/m², followed by Greece and Italy with 1,693 kWh/m² and 1,611 kWh/m², respectively. Global radiation is significantly lower in Germany at 1,147 kWh/m², while the corresponding value amounts to 1,169 kWh/m² for the Czech Republic and 1,386 kWh/m² for France. The density of photovoltaic capacity measured in terms of Watt peak (Wp) per inhabitant (inhab), on the other hand, is highest in Germany (212 Wp/inhab), followed by the Czech Republic (186 Wp/inhab). In sun-rich Spain the density of solar power installations amounts to 83 Wp/inhab, while Italy, another large country in the European sun belt, ranks only fifth with 58 Wp/inhab (see Figure 3 below).

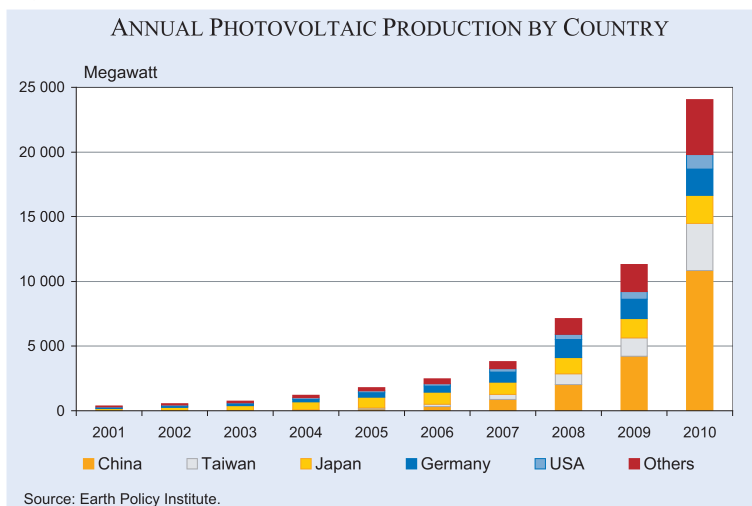
The phenomenon of relatively high solar electricity production in regions with rather low sun exposure is closely related to the predominant way of promoting solar power in the EU: 18 of its 27 member states foster renewable energy, and especially solar power, by means of feed-in-tariffs (see REN 21). In this context the operators of photovoltaic installations enjoy a guaranteed price for each kWh produced, which covers their production costs that significantly exceed market prices. In other words, the promotion of solar power is not based on economic efficiency considerations and promotes a rather expensive method of reducing carbon dioxide emissions.

Over 40 countries worldwide have introduced such feed-in-tariffs for electricity gained from renewable energies (see EPIA 2011). In 2010 the global production of solar cells and modules doubled compared to 2009, reaching 23.9 GW solar cells and 20 GW of modules. At the same time, the prices of solar modules decreased by 38 percent in 2009 as a result of the rapid expansion of the production capacities for polysilicon and wafers in China and other Asian countries (see REN 21).

In recent years the production of solar cells and modules has predominantly taken place in countries with a low domestic use of solar electricity. In China, for example, no promotion of solar electricity exists on a national level, there is merely some local feeding remuneration (see EPIA 2011). China has nevertheless been the global leader in solar cell production since 2008. In 2008 Chinese manufacturers produced 2 GW, followed by their German competitors with a production of 1.4 GW and by Japanese enterprises with 1.3 GW. In 2009 Chinese production doubled to 4.2 GW, while German and Japanese production, on the other hand, increased only slightly to around 1.5 GW in each country, and photovoltaic companies from Taiwan achieved a healthy1.4 GW. In 2010 both China and Taiwan increased their production by a factor of 2.5 and reached peak values of 10.9 GW and 3.6 GW respectively, putting them a long way ahead of Japan with 2.1 GW and Germany with 2.0 GW. However, US manufacturers also nearly doubled their production in 2010 to 1.1 GW compared to 0.6 GW in 2009 (see Figure 4).

The largest discrepancy between the production of solar cells and domestic use of solar energy can be

Figure 4



Source: Earth Policy Institute.

[2] Global radiation is the total short-wave radiation from the sky falling onto a horizontal surface on the ground. It includes both the direct solar radiation and the diffuse radiation resulting from reflected or scattered sunlight. (see PIK research portal, available online at http://www.pik-potsdam.de/services/infothek/climate-weather-potsdam/climate-diagrams/global-radiation/index_html).

identified in China, where the production of solar cells was twenty times higher than photovoltaic installations in 2010. In the United States the production of solar cells was also around 30 percent higher than capacity extension in the same year. In Germany, however, only 27 percent of the new installed capacity was produced within the country in 2010, while the rest was imported. In 2009 this ratio reached 39 percent, and was even as high as 78 percent in 2008. This contradiction reveals the disadvantages of an environmental policy that subsidizes certain environmental technologies, instead of using market-based instruments corresponding to the polluter-pays-principle.

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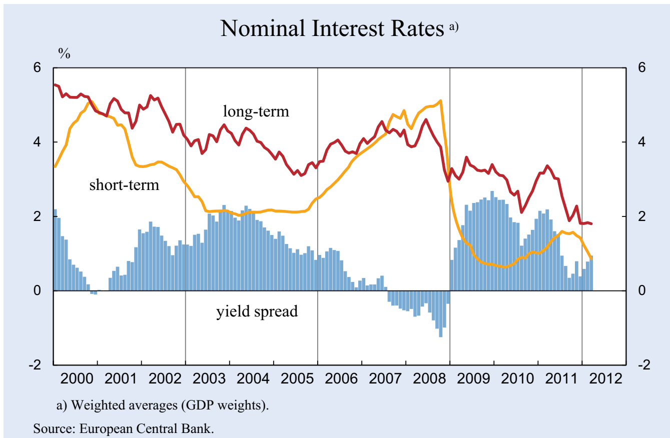
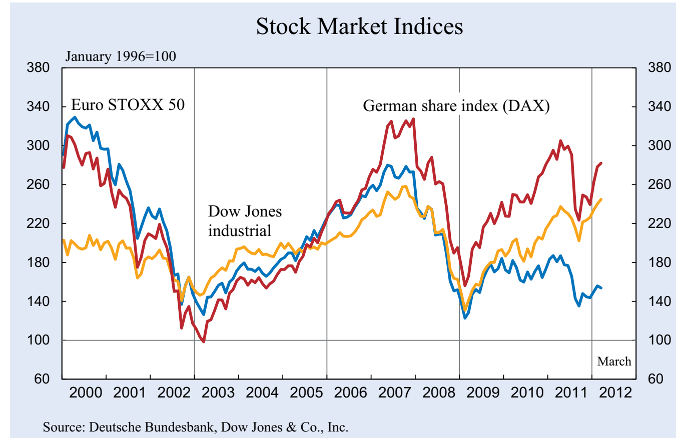
Financial conditions in the euro area



a) Weighted averages (GDP weights).

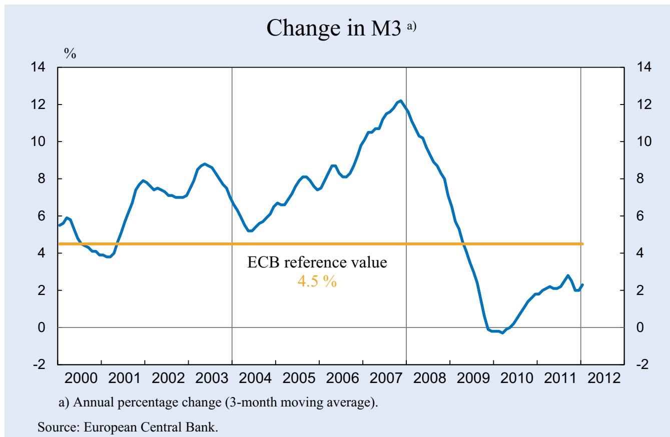
Source: European Central Bank.

In the three-month period from January to March 2012 short-term interest rates decreased. The three-month EURIBOR rate declined from an average 1.22% in January 2012 to 0.86% in March 2012. Yet the ten-year bond yields remained unchanged which amounted to 1.81% in January as well as in March 2012. In the same period of time the yield spread increased from 0.59% to 0.95%.



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

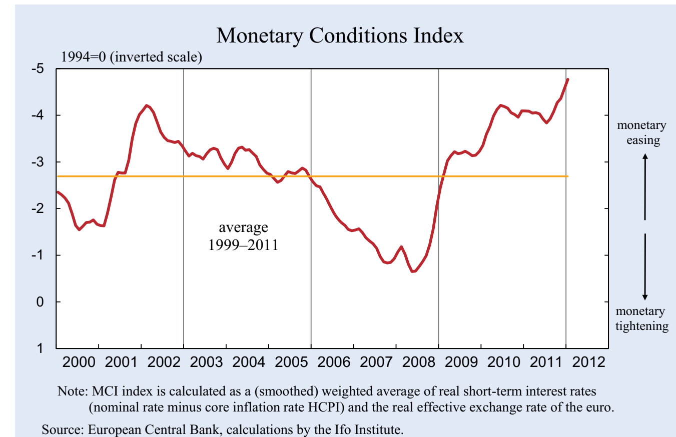
The German stock index DAX increased in March 2012, averaging 6,947 points compared to 6,458 points in January 2012. The Euro STOXX also increased from 2,416 to 2,477 in the same period of time. Moreover, the Dow Jones International grew, averaging 13,212 points in March 2012 compared to 12,633 points in January 2012.



a) Annual percentage change (3-month moving average).

Source: European Central Bank.

The annual growth rate of M3 increased to 2.8% in February 2012, compared to 2.5% in January. The three-month average of the annual growth rate of M3 over the period from December 2011 to February 2012 increased to 2.3%, from 2.0% in the period from November 2011 to January 2012.

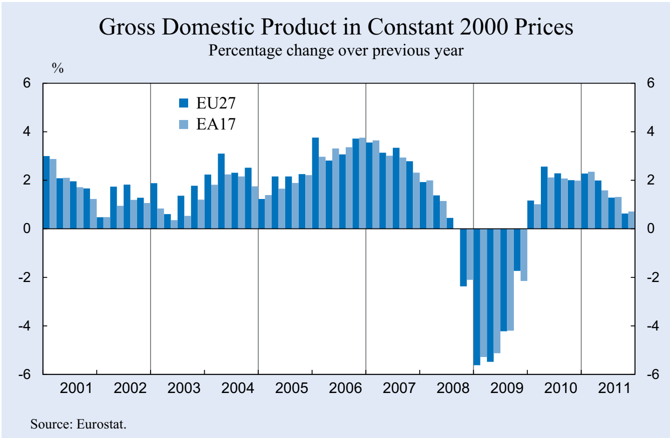


Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

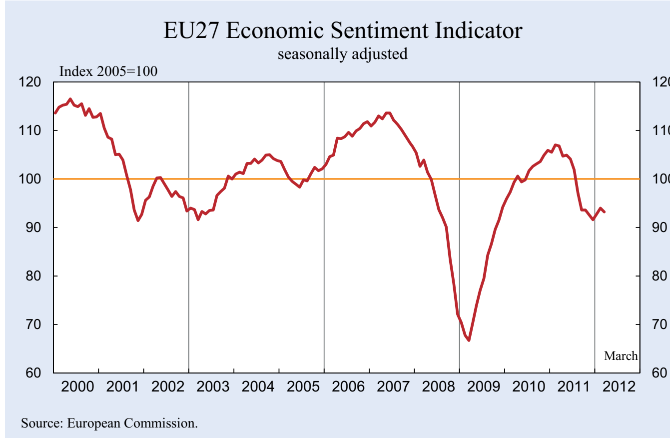
Source: European Central Bank, calculations by the Ifo Institute.

Between April and November 2009 the monetary conditions index remained rather stable after its rapid growth that had started in mid-2008. The index started to grow again since December 2009, signalling greater monetary easing. In particular, this has been the result of decreasing real short-term interest rates. In January 2012 the index has continued its fast upward trend started in August 2011 and reached its peak.

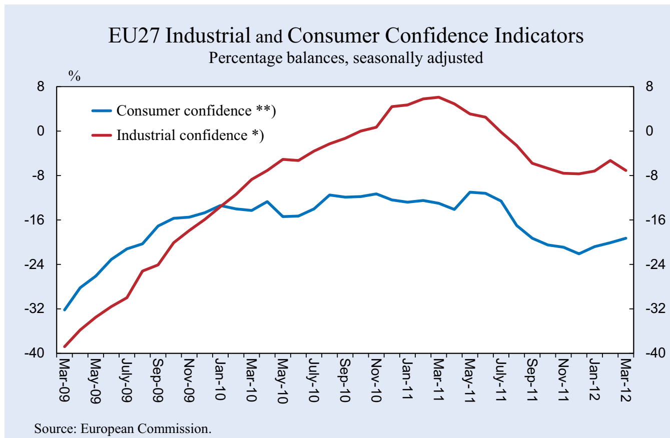
EU SURVEY RESULTS



According to the second Eurostat estimates, GDP decreased by 0.3% both in the euro area (EU17) and the EU27 during the fourth quarter of 2011, compared to the previous quarter. In the third quarter of 2011 the growth rates were 0.1% in the euro area and 0.3% in the EU27. Compared to the fourth quarter of 2010, i.e. year over year, seasonally adjusted GDP rose by 0.7% in the euro area and by 0.9% in the EU27.

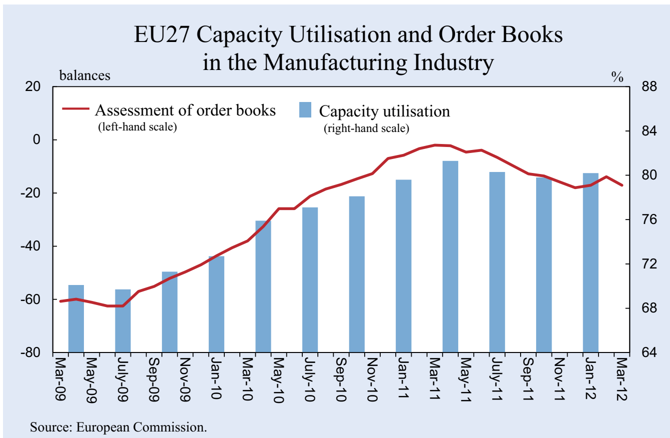


After improving in January and February, the Economic Sentiment Indicator (ESI) decreased in March 2012 by 0.8 points in the EU27 and by 0.1 points in the euro area (EU17), to 93.2 and 94.4 respectively. In both the EU27 and the euro area the ESI stands below its long-term average.



* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

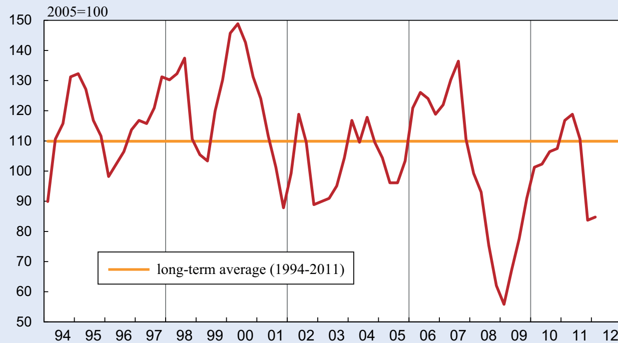
In March 2012, the *industrial confidence indicator* declined in both the EU27 (– 1.8) and the euro area (– 1.5). On the other hand, the *consumer confidence indicator* increased in both the EU27 (0.8) and the euro area (1.2).



Managers' assessment of *order books* worsened from – 13.9 in February to – 17.1 in March 2012. In January 2012 the indicator had reached – 17.1. *Capacity utilisation* also slightly decreased to 80.2 in the first quarter of 2012, from 79.8 in the previous quarter.

Euro area indicators

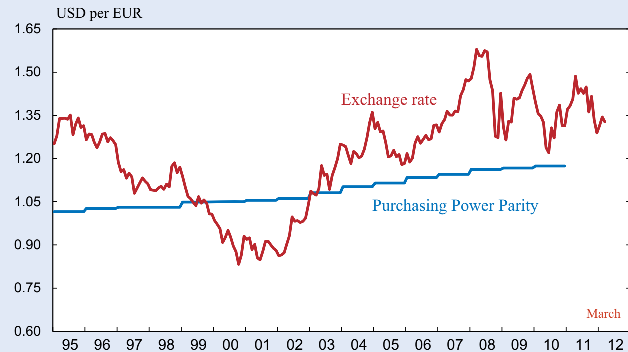
Ifo Economic Climate for the Euro Area



Source: Ifo World Economic Survey (WES) I/2012.

The Ifo indicator of the economic climate in the euro area (EU17) rose slightly in the first quarter of 2012 after two successive decreases, but nevertheless remains significantly below its long-term average. Appraisals of the current economic situation continued to deteriorate. The only positive trend was seen in the six-month outlook, which brightened somewhat compared to the fourth quarter of 2011. It is too early to speak of any general recovery in the euro area.

Exchange Rate of the Euro and PPPs

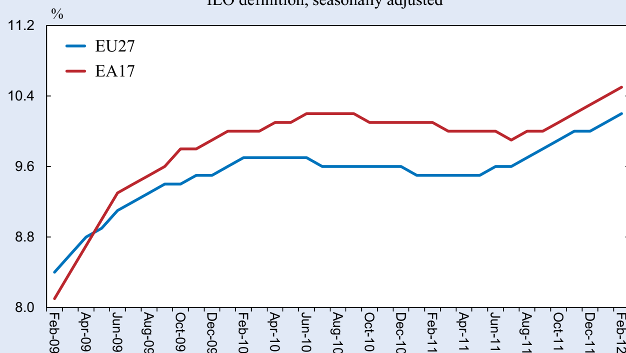


Source: European Central Bank, OECD and calculations by the Ifo Institute.

The exchange rate of the euro against the US dollar averaged approximately 1.33 $/€ between January and March 2012. (In December 2011 the rate had amounted to around 1.29 $/€.)

Unemployment Rate

ILO definition, seasonally adjusted

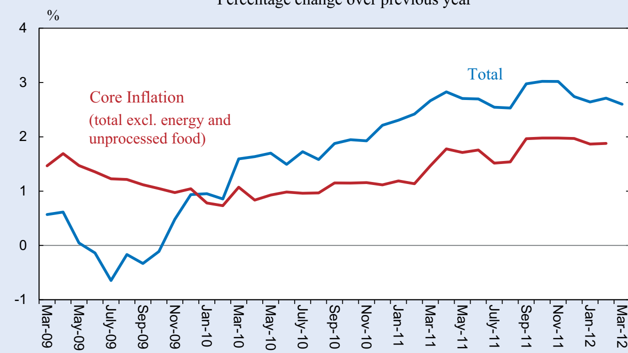


Source: Eurostat.

Euro area (EU17) unemployment (seasonally adjusted) amounted to 10.8% in February 2012, compared to 10.7% in January. It was 10.0% in February 2011. EU27 unemployment stood at 10.2% in February 2012, compared to 10.1% in January. The rate was 9.5% in February 2011. In February 2012 the lowest rate was registered in Austria (4.2%), the Netherlands (4.9%), Luxembourg (5.2%) and Germany (5.7%), while the unemployment rate was highest in Spain (23.6%).

Inflation Rate (HICP)

Percentage change over previous year



Source: Eurostat.

Euro area annual inflation (HICP) was 2.7% in February 2012, unchanged compared to January. A year earlier the rate had amounted to 2.4%. The EU27 annual inflation rate reached 3.0% in February 2012, up from 2.9% in January. A year earlier the rate had been 2.9%. An EU-wide HICP comparison shows that in February 2012 the lowest annual rates were observed in Sweden (1.0%), Greece (1.7%) and Spain (1.9%), and the highest rates in Hungary (5.8%), Estonia and Poland (both 4.4%). Year-on-year EU17 core inflation (excluding energy and unprocessed foods) slightly increased to 1.88% in February 2012 from 1.87% in January.

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HANS-WERNER
SINN

Neu erschienen bei:
The MIT Press
Cambridge, Massachusetts, and London, GB
February 2012

288 p., 36 figures, 8 tables, cloth – $29.95/£20.95

ISBN-10: 0-262-01668-0
ISBN-13: 978-0-262-01668-1