EMU at Crossroads

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The European Monetary Union (EMU) is certainly in a crisis. There can be no doubt that the recent rescue plans and packages of the past months were necessary to stabilize the euro area and the financial markets in the short run (Bundesbank 2011). However, it remains questionable whether this rescue path will lead to a sustained framework of economic governance in the EMU. There is a huge danger that the EMU will follow the wrong path – i.e. that of a short-run rescue philosophy (The Economist 2011). We argue that the consequences of following the current short-run policy will lead to a future break-up of the EMU. Learning the lessons from sovereign debt crises, in other words, identifying the failures before this crisis emerged, is essential to the process of building a new and sustainable European economic governance framework.

The current rescue philosophy of helping indebted countries with guarantees on the one hand and demanding strict austerity on the other hand is merely appropriate as a short-run stabilization of EMU. However, this rescue strategy does not address the structural problems and improper incentives of participating countries in the medium and long run. There is a substantial danger that policymakers will follow the wrong stabilization policy because of political path dependency. This short-run policy response might create even more moral hazard and free-riding, thereby putting the whole EMU at risk. A solution to its structural problems requires an answer to the question of why the EMU is in such a mess?

The monthly frequency of new stabilization packages for Greece, or even the entire banking system, illustrates that the EMU is at a crossroad. The past and present problem is the existing weak and non-credible economic governance framework, and more specifically, the ineffectual enforcement of existing rules on fiscal discipline. There have been hardly any officially defined consequences in cases where countries violated fiscal rules since the foundation of the EMU in 1999. Strengthening economic governance with respect to fiscal discipline and strict conditionality is necessary to sustain European Monetary Union. Even the recently proposed economic governance reforms like the Euro-Plus Pact, the Reform of Stability and Growth Pact (SGP), European Semester, European Strategy 2020, and the European Stability Mechanism (EMS) are not far-reaching enough to tackle all of present and future structural problems (Herzog 2011).

A long-run stable and sustained economic governance framework needs two arms: firstly, a more depoliticized enforcement mechanism for breaching countries, and secondly, immediate and tough consequences for countries that do not comply with the defined (*ex ante* conditions of) fiscal rules. In the past year the European economic governance framework has changed dramatically. A new rescue net called the 'European Financial Stability Facility' (EFSF) has been created for all EMU countries. This has led to fewer incentives for each member state to bear the consequences of its own fiscal policy decisions. Despite the fact that the EFSF requires countries under the rescue umbrella to implement austerity measures, this umbrella simultaneously enforces moral hazard. Furthermore, what is to be done with countries that do not comply with the rules or implement the required austerity measures?

In a nutshell, we must establish a new balance between the 'rescue' incentive structure, on the one hand, and fresh demand for stricter fiscal discipline and tougher *ultimo ratio* sanctions, on the other. Since the first reform discussion on the Stability and Growth Pact in 2005, there have been demands for either an automatic enforcement or cession of sovereignty to an independent EMU body. This paper argues that, in extraordinary cases of fiscal cheating over a period of more than four years, an automatic

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ultimo ratio option is required for those countries: either to lose sovereignty or be excluded.

What is wrong with European economic governance?

The bad news is that all of the European economic governance safeguards to date – the Maastricht Criteria, the Broad Economic Policy Guidelines (BEPGs), and the Stability and Growth Pact – have had little to no effect over the past decade. Since the foundation of EMU economic governance in the 1990s, there has definitely been room for improvement in several areas: (i) the selection process of economically and fiscally sustainable member countries was not binding and strict enough, (ii) the economic coordination processes were rather weak and have proven totally ineffective, (iii) the enforcement of the Stability and Growth Pact has not worked in political practice, and (iv) the lack of an exchange rate mechanism in the euro area, which typically provides a disciplining mechanism for countries, has generated a lack of fiscal discipline (free-riding), and has failed to inspire any further efforts towards structural economic reform. On the contrary, the existing framework and the recent rescue nets have promoted free-riding and moral hazard.

For the past decade overall EMU governance has been weak and policymakers did not see any need to improve it. In the end, euro area policymakers have accepted nearly every potential member state that attempted to achieve the five Maastricht or Convergence Criteria (European Commission 2011). Even at the time of the EMU foundation in 1999, almost no country was in line with all of the thresholds of the Maastricht Treaty. The same applied to Greece in 2001. Moreover, the entrance criteria are no guarantee for convergence within the EMU. In the past decade, we have witnessed growing divergence in terms of competitiveness, as well as growing inflation and growth differentials. All this indicates the failure of the existing economic governance setting and probably also points to a weak selection process.

The so-called 'Broad Economic Policy Guidelines' were just an alibi for policymakers without any effective function and sanction. Despite the goal of coordinating social and labor policy in Europe, no credible incentive and/or enforcement mechanism was put in place to achieve this goal. However, the idea of a common goods and capital market requires a certain degree of coordination – some even argue in favor of comprehensive harmonization. In hindsight the movement towards coordination or harmonization in terms of fiscal policy was fairly invisible. Most reforms, on the other hand, strengthened national sovereignty and national exceptions.

The financial crisis and the sovereign debt crisis illustrate this reality: financial markets are international, but their regulation is effectively national. The fact that some people say 'banks are international in life, but national in death' (Goddhart 2009), is neither true in a monetary union nor in an interconnected world. The case of Ireland taught us that the costs of bank bail-outs are not just born by Irish taxpayers, but by all European taxpayers. This illustrates the need for European coordination in terms of both economic and financial regulation/supervision on a supranational level. Moreover, the cases of Greece, Portugal, Italy and Spain illustrate the need for structural reforms in social and labor policies. There is simply no other way to regain competitiveness in a monetary union. Hence, some coordination of these policy fields is essential to EMU. Let us consider simple example: politicians in all countries, and particularly those with a weak competitiveness structure, have to learn that 70 percent of national inflation is caused by excessively high wages (ECB 2009 and 2011) and one reason for the latter is wage indexation rules. Furthermore, it is hard to explain to people in highly competitive countries why they must work until they are 65 or 67 years old, while people in troubled countries have a legal retirement age of 60. All this does not generate European solidarity or the requisite willingness to pay in emergency cases. We definitely need greater coordination in all economic policy areas.

The Stability and Growth Pact, which was implemented to discipline fiscal policy within the EMU, was a clear effort to move in this direction. However, political unwillingness and improper institutional design made the pact difficult to enforce. Since its implementation in 1997 there have double-digit violations of the Stability and Growth Pact, none of which gave rise to appropriate sanctions. Hellwig (2011) rightly concluded that: "the lack of credibility of the Stability and Growth Pact was identified as a problem [long before]. Therefore it seemed likely that, at some point over the medium run, we would come across a problem like the one that Greece has posed over the last year". Since the adoption, and particularly during the reform discussion of the SGP in 2005, economists have proposed over a hundred alternative ways of improving the existing Stability and Growth Pact

(Fisher *et al.* 2006). There was, however, no political will to do so!

Now it is time to learn the lessons of the past and change improper political ideology and strategy in Europe. Apart from the Stability and Growth Pact's weak institutional design and its enforcement problems, there are further unseen issues: the Pact does not focus enough on long-run debt sustainability and the 60 percent of GDP debt limit. Both issues did not trigger any sanctions. The fact that Ireland did not even appear on the radar screen of the SGP illustrates the Pact's weaknesses and potential for optimization.

Finally, the lack of an exchange rate mechanism in EMU has destroyed the international competitiveness of important industries in some European countries. Usually, the loss of competitiveness affects the exchange rate, but in a monetary union with irrevocably fixed nominal exchange rates that disciplining mechanism does not work. Eichengreen and Hausmann (1999) showed that normal state lenders distrust such governments and therefore refuse to lend in the country's currency. If Greece and Portugal had possessed their own currency, they could have devalued it now. However, both would not have been able to borrow in their own currencies without the common euro in the first place. This illustrates another reason for the lack of fiscal discipline. The common currency and missing exchange rate mechanism reduced the incentives for economic reforms, and especially wage restraints, in the euro area. Moreover, (financial) market participants have learned quickly – particularly in the case of Ireland, Greece, Portugal and recently Spain, Italy and France – how to gamble with national EMU member states and in the end the whole euro area.

Altogether the inexistent economic governance framework and the rescue procedures during the sovereign debt crises have led the EMU down the wrong path. This constellation put all national governments and the EMU at risk. To resolve the current crisis, we have to look for new solutions and innovative institutional rules. Otherwise the EMU's very existence is at risk. The majority of economists are convinced that the EMU is economically necessary in a globalized world and good for the welfare of all citizens. However, if citizens want to have a steady and sustained monetary union in the future, policymakers must proceed with new rules to safeguard the economic success and unprecedented price stability of the EMU.

What next? Master plan and policy recommendations

EU policymakers are still far from finding the right way out of the sovereign debt crisis and towards a long-run sustainable framework. The good news is that there is an appropriate solution, and after implementing new rules the European Monetary Union will no longer be in danger!

Below I develop a kind of master plan to re-establish stability within the EMU. In general there are two options. Both options, however, do not work unless the credibility of the existing framework can be re-established and enhanced. Option A constitutes a fundamental change to the existing policy framework of EMU. This option would insist that EMU member states abandon a substantial part of their national sovereignty over fiscal policy. This would require immediate, fundamental legal changes on a European and national level. The recent judgment by the Constitutional Court in Germany has more or less eliminated this option for the near future (Bundesverfassungsgericht 2011). A European state is not possible within the current German constitution and it would require major changes in law. Let us labour under no illusions: the path towards adopting this option is long, difficult and calls for the broad support of all of the citizens in all euro area member states. An approach featuring a European state with a European government responsible for a budget is currently not a realistic solution. The political will for doing so is not available, popular support is lacking and there is no blueprint for proceeding along that path.

More realistic, however, is option B. This is based on strengthening the fiscal incentives for sound fiscal policy within the current framework. Option B requires a return to plus an enhancement of the fundamental principles of a monetary union:

- Each member state has to bear the consequences of its own fiscal policy decisions,
- Market interest rates are the disciplining mechanism of unsound debt policy,
- Automatic enforcement mechanisms of the rule-based framework (Stability and Growth Pact),
- Implementing new mechanisms to avoid growing differentials in terms of growth, inflation, current account etc., and
- *Ultimo ratio* punishment options for notoriously unsound countries.

The key philosophy of option B is that countries bear the full responsibility of their own policy decisions in

combination with a rule-based and decentralized framework. Consequently, it represents a return to a strict no-bail-out clause (Article 125 of the Treaty on the Functioning of the European Union). Moreover, the European Central Bank (ECB) must go back to its primary objective of price-stability and has to abide by the prohibition of monetary financing (Article 105 and 123 of the Treaty on the Functioning of the European Union).

Such a rule-based framework, together with pressure from the financial markets, would be able to preemptively discipline fiscal policy in the euro area. Hence, the basic idea of the current rule-based approach is not dead (Issing 2011; Weidmann 2011). What makes it weak and almost dead, is the past and current implementation of the rules, especially the weak enforcement and political discretion involved in EMU economic governance. The combination of domestic fiscal responsibility with automatic control mechanisms *via* rules and markets would be as efficient as a European State from an institutional economic view. Both enhance financial stability and the stability of EMU.

Both options offer sustainable solutions from an economic point of view. However, the first option is unrealistic and the second also calls for major changes within the existing framework. A combination of both options, however, i.e. sharing the risks of unsound fiscal policy and retaining national sovereignty over fiscal policy, is also doomed to fail as we can see from the short-run rescue strategy. Such a policy would undermine the incentives for sound fiscal and economic policy even further, thus achieving the opposite of stabilizing the EMU.

The timing of the next reform steps and policy changes is critical to regaining stability within the EMU. Hence, we have to discuss the essential policy proposal to stabilize the EMU according to option B. The new economic governance framework must be strengthened and extended in several ways. The following new elements need to be implemented in the near future:

Proposal 1: *define ex ante conditionality for all participating EMU member countries.*

The major underlying policy problem of the rescue packages during the sovereign debt crisis and the financial crises is moral hazard. To tackle this problem, we need consistent incentives to maintain sound public finances and more conservative approach to risk exposure – in short, lower debt levels. We therefore propose a turnaround of the EMU incentive structure. If a country is selected as member of the EMU, it must agree to abide by all criteria and rules on accession and regularly thereafter. I would call this *'ex ante conditionality'*, which defines mandatory conditions for all countries participating in the EMU. These conditions are: sound public finances, (i.e. in line with the deficit and debt threshold of SGP *and* a balanced budget in the medium term), conservative wage policy, and economic reforms to enhance economic growth and finally competitiveness. Any violation of these criteria or rules should immediately trigger sanctions because the mandatory conditions of EMU are breached – like the *conditionality* of austerity plans in the current rescue packages – to achieve a sustainable EMU.

At present the conditionality (of austerity plans) is unfortunately implemented too late. In fact, we do not demand conditionality until after a crisis has prevailed. Every country, however, has benefited from the EMU since the beginning, without following the necessary rules in terms of fiscal policy. Therefore, the existing governance framework sets the wrong incentives at the wrong time. We must make the conditionality of EMU membership countries *ex ante*. This will be more efficient, less procyclical and avoid moral hazard. It clearly illustrates to all members of the EMU that membership requires sacrifice and fiscal discipline on a daily basis. If a country fails to perform accordingly it is fair to punish or sanction it right from the beginning. However, the sanctions we need in such a new framework should be stricter and, at best, enforced automatically (see proposal 3 below).

A further advantage of *ex ante* conditionality is the continued existence of cultural difference in attitudes towards sound fiscal policy and price-stability within the EMU. To further adjust and smooth European attitudes and solidarity, the effective functioning of those incentives and mechanisms is essential. This enhances economic growth and competitiveness. Today, for example, wage setting mechanisms are quite different in Europe. This issue is part of the current competitiveness problem.

Proposal 2: *reform the Stability and Growth Pact: (i) introduce immediate sanctions for violations of the deficit and debt threshold and the goal of a balanced budget in the medium term and (ii) improve enforce-*

ment either with an automatic or a vote and reputation mechanism.

The Stability and Growth Pact (SGP) needs to be strengthened further in two directions. Firstly, an excessive debt level should trigger sanctions as a deficit violation of today. Similarly, a violation of long-run sustainability, defined as a balanced budget in the medium run, should also call for sanctions too. Secondly, we have to improve enforcement of the SGP which remains weak. There are two options: either autonomic sanctions or reduced sovereignty in the case of a breach. The last idea refers to a vote and reputation function developed by Casella (2001) and Herzog (2004b and 2004c). The optional loss of sovereignty, but only in case of policy failures, would discipline euro area member countries even more than today's measures. Such an intrinsic punishment of sovereignty losses outweighs the current extrinsic incentives of monetary sanctions (Herzog 2004a). Moreover, this sanction idea is not pro-cyclical on the budget and avoids today's moral hazard incentives. In sum, even the recent reform proposal of the Stability and Growth Pact, expressly consented by the European Parliament on 28 September 2011, is not enough to implement the urgently needed, long-run incentives elaborated in my proposal.

Moreover, an automatic mechanism or a vote and reputation mechanism goes much further than the new 'inverse majority' voting rule (Herzog 2011). It is the only fair mechanism in a supranational monetary union under fiscal-monetary interaction and national fiscal policy. As long as a country is in line with the European rules and principles, especially in fiscal policy, its sovereignty remains 100 percent national. However, as soon as a country breaches the SGP, it must give up some sovereignty to the supranational level because 'unsound' national policy triggers – in the worst case – negative externalities for other EMU countries. The current sovereign debt crisis illustrates these negative externalities in terms of financial market instability, new mistrust in the banking sector, further speculation over public debt in other countries and overall exchange rate speculations against the euro currency. Hence countries have full sovereignty and voting power if they are in line with the founding principles of the EMU, whereas unfulfilled founding principles will lead to reduced sovereignty rights and voting power for the concerned countries. This sanction mechanism is economically efficient, fair and necessary to ensure the long-term stability of EMU. An automatic mechanism is fairly similar. However, an automatic sanction procedure goes even further than a vote and reputation mechanism because there will never be any political discretion. The concept of European fiscal government goes further again than automatic sanctions. In this scenario even the sound countries lose their national sovereignty at all times. This is an evident violation of the subsidiarity principle in Europe. Furthermore, a vote and reputation function is a better complement to the idea of the guiding principles of *ex ante conditionality* in proposal 1.

The proposal of a voting and reputation function is a kind of *ex ante* conditionality in case of policy failures. Consequently, it almost imitates – in the case of a breach – an automatic sanction mechanism. The breaching countries only have little or no voting power and are therefore unable to block decisions on a supranational level. The SGP will not work as long as the policymakers, whose job it is to enforce them, are not motivated by economic incentives or the political power to do so. A transparent incentive to align with the deficit and debt criteria will also enhance the credibility of economic governance in the future, because every country will know in advance that any violation will trigger a significant loss of sovereignty.

A recent proposal by Lauk and Wiesheu (2011) argues in the same direction. They propose linking voting power in the ECOFIN council with the official ratings of a government. Only countries with a triple AAA rating should have the right to vote. This implements both a market control instrument and a sound incentive structure. However, I would argue that this singular link is not a good idea because we further bow to the rating agencies. The judgment of a rating agency can be, and has not always been true and timely enough. Think about the situation with Greece and Italy. The downgrade of Greece and Italy came far too late. Moreover, such ratings are sometimes biased too. Therefore, the judgment of rating agencies is just one step towards evaluating sound countries. Other criteria must include: deficit and debt levels, stringency of the national debt rule, the competitiveness level of a country, its potential growth rate and its national price stability.

Furthermore, in the past decade even the European Commission has failed in its official role as a guardian of the treaty. The Commission failed during all enforcement processes and the SGP reform in 2005.

The Commission has not improved the enforcement mechanism during the reform discussion and has not protected the no-bail-out clause in the recent sovereign debt crisis. To tackle the weaknesses of the current Stability and Growth Pact, it needs – without any hesitation – a stricter enforcement process, less political impact and discretion and, finally, more automatic processes.

Proposal 3: *either sovereignty loss or a principle of exclusion is needed, in case of unsound fiscal policy. This ultimo ratio threat makes sound fiscal policy priority 1 and finally helps to avoid moral hazard.*

Due to the specific constellation of fiscal-monetary interaction and the rescue umbrella incentives of the EFSF and later on the EMS, we need some new final incentives to promote sound fiscal policy. Firstly, we recommend an absolutely strict no-bail-out clause and only in special, rare cases do we allow the EMS to take up a kind of lender-of-last-resort function. This, however, is combined with even stricter austerity conditions. Secondly, for a long-run sustainable monetary union, we also propose to implement the exclusion principle for unsound EMU member states as an *'ultimo ratio'* option. In other words, countries violating fiscal rules for more than four years in a row either lose fiscal sovereignty completely or have to leave the EMU. After fulfilling the criteria of *ex ante* conditionality and all required fiscal criteria, a country will either regain national sovereignty, or, in case of its exclusion, be given the option to rejoin the EMU under specific constraints.

Proposal 4: *democratizing European economic governance.*

The new rules (regulations) and/or institutions of European economic governance must serve the purpose of democratizing fiscal policy. This means serving each national citizen best by maintaining a national policy system and only integrating supranational coordination in special cases. However, if a country fails to consolidate the public budget or to enhance domestic competitiveness, the supranational level should increasingly take responsibility for this specific country. Under normal circumstances, we recommend an environment where fiscal policy is applied effectively on the national level to promote national needs. This should enhance the welfare of the domestic population and that of neighbor countries and businesses best. Of course, people matter to every economy, which is why in case of sustained fiscal policy failures we should enable the fiscally sound countries to decide how to dispose of their taxpayers' money, as they already do in the national context. Hence, the new rules and principles must serve European citizens, making our institutions more democratic and better prepared to deal with crises and risks. That means taking account of the actual incentives that are created by our existing rules at all times.

For the past decade, the European Commission and other institutions have missed the point of fiscal discipline and the need for economic coordination. This is due to three factors: bad institutional design, a lack of any political will and the limited capabilities of supranational institutions. Does this mean that the European regulatory framework will always fail? No! That is tantamount to saying that there should be no referee in a football game, because he is inherently less capable of playing the game than the players are. In fact, the referee is a key element in all games – in football and in the EMU. Only with a referee can the best players show their real talents. Thus, figuratively speaking, referees and good rules prevent countries from playing roughly and unfairly by supporting fair-play for the best or most competitive countries.

Conclusions

The European Monetary Union will not fail and the integration process will not be reversed if policymakers implement stricter and more consistent rules, as well as new incentives promoting more sustainable solutions. Our proposed mechanisms will create a well-founded EMU in the long run. Policymakers have to learn that Europe, and particularly fiscal policy in a monetary union, is continuously hard work. This has been shown by all historical monetary unions over the past 200 years (Theurl 1992).

First and foremost, we have to get rid of the arbitrariness of fiscal rules and economic governance. Democratizing European economic governance means paying attention to all European taxpayers during economic crises as well as under normal circumstances. Hence, the lesson is not necessarily to become an ear of the political union or a 'European Government', but to refine, extend and enhance existing rules and complement these supranational rules and institutions with better enforcement procedures, economic incentives and sanctions.

We must design – similarly to our proposals – the rules in a way that they serve the people best and promote growth as well as competitiveness. Democratizing European economic governance does not impose clumsy rules, barriers or restrictions which reduce people's welfare. Current policymakers have the opportunity to learn the lessons and implement the outlined recommendations. They have to put together the right incentives to make the European Monetary Union really irrevocable (Duisenberg 2004), otherwise a failure of the EMU is sadly only a matter of time, as shown by the history of supranational monetary unions.

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