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The German Argument for a Two-Speed Solution to EU Political Crisis

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MAASTRICHT: Variable Velocity

- Treaty on European Union to insure "Single Internal Market"

  A Common Currency for the Common Market: Euro Timetable, Entry conditions and ECB

- **No timetable, No conditions for Political Unification**
- Issing:"The vast majority of German economists advocated the so-called economists' view that monetary union should be the final step in a long process of European integration.
- But in 1999, 11 heterogenous countries embarked on a highly ambitious act towards Economic and monetary Union (EMU), despite concerns that the euro might fail.
- As an economist, I shared the German view."

Monetary Sovereignty

"Historical experience shows that national territories and monetary territories coincide. … the relevant legislation as a rule defined monetary sovereignty in relation to a national territory. …

… In contrast to the normal rule, the Maastricht Treaty implies a clear discrepancy between the intentionally rather modest political integration and monetary integration."

Political limit to monetary integration

- "After a certain point, economic integration cannot realistically be expected to advance further without the prospect of further progress in the field of politics.
- The transfer of an elementary sovereign right such as monetary policy to a European Central Bank is likely to mark that point."
- Hans Tietmeyer, 1995

Role of Political Integration

- With common currency negative external shocks have to be met with increased (downward) wage flexibility and labour market conditions since devaluation is no longer a policy option
- Political unification must support redesigned (hardened) labour market adjustment, not harmonization of social safety nets (at highest common denominator)
- Common currency reduces government incentive to prudent fiscal policy because there is no exchange rate risk nor market discipline through interest rates, absorbed by common interest rate policies.
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Role of Political Integration

- National differences in unemployment and commitment to fiscal prudence will produce political pressure for compensation from the wealthier or less indebted to the poorer or more indebted areas.
- This undermines political solidarity and support for common monetary policy.
- It may even undermine the ability of the ECB to establish the price stability that is the prerequisite for the EURO to be established as a credible alternative to national currencies.

In the Absence of Political Integration: Regulation of National Policy

- Single Currency and Article 104 (123) on ECB lending to governments
- Means governments cannot fund themselves and borrowing will depend on private market conditions
  - Governments need to run fiscal surplus to fund
  - Governments need to run fiscal surplus to keep AAA credit rating that allows borrowing
  - (Except BIS gave AAA irrespective of fiscal/debt position)

SGPact and 6 Pack, 2 Pack

- To avoid the moral hazard created by the gap between monetary and political unification
- While the conditions for entry are strict, and failure to meet them produces the ultimate sanction: exclusion from the Euro
- **After entry, there are few sanctions for failure to maintain entry conditions**.
- Thus, you need incontrovertible pre-entry proof and hard post entry sanctions that debt and deficit conditions will be met.
- And this requires strong political unification.

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The Euro Experience

- The German Example:
  - Reduce fiscal deficits caused by E. German unification
  - Reduction in Social Welfare System
  - Increased flexibility in labour markets
  - Wage increases below productivity
- The Rest:
  - The failure of the rest EU to follow these policies has produced precisely the kind of political pressure for internal transfers foreseen in 1996

Post-1999 Policy

- "The 11 countries the joined the Euro were heterogeneous.
  - Now there are 19: heterogeneity has increased.
- The obvious challenge … was to continue with the convergence process
- There was no speed-up of convergence after 1999 – rather, the opposite.
- From day one, quite a number of countries started working in the wrong direction. …
- Quite a few countries – including Ireland, Italy and Greece – **behaved as though they could still devalue their currencies.**
- Of course there is a problem if wages rise by more than productivity.
- So the problem accumulated over time, and only stopped because of the crisis."

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Political Failures and Euro Crisis

- "As long as member countries remain sovereign states, they need to abide by the Stability and Growth Pact.
- Germany and France violated the Pact in 2003, delivering a fatal blow to the Pact from which it has never recovered.
- **Now the EC more or less ignores it.**
- These political failures had to lead to a crisis that was aggravated by the collapse of the financial markets on a global scale."

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And the ECB is Complicit

- What is missing is a common understanding that the European Union is a community of sovereign states with a common monetary authority, the ECB.
- The key element of national sovereignty – fiscal policy – lies with individual states.
- There is no likelihood of political union in the near future.
- So a monetary union with fiscal sovereignty of member states can only continue if there is a no bailout clause.
- Today, the no bailout clause is violated every day, de facto.. I would not expect the ECB to say: "From now on, nations must be compliant with the rules." But the direction should be towards adhering to the rules.

No Bailout Clause

- However , there are still many politicians stating there will be a mutualisation of debt with political union coming later – so the moral hazard is overwhelming.
- If politicians could clarify this political debate – which never occurs, despite all the summits in Brussels – to unite and say that political union is a vision at best, and stop giving the impression that political union is around the corner, it would create the opportunity to move in a direction where the no bailout clause is taken seriously.

Variable Velocity to Two Speed

- Within the monetary union, the idea is one speed. My preference would have been that when it was obvious its debt situation was unsustainable –
- **no more financial support would have been granted to Greece, and the country would have had to leave the euro.**
- After that, the EU would offer all the support it could to Greece to help its economy recover and ensure that it could rejoin the euro from a much stronger position.
- What initially took place was that a bailout occurred that saved the banking system –
  - and mainly stopped French and German banks from incurring losses in Greek bonds.
- It created a situation with all the wrong incentives.
- **It would have been better to demonstrate a country could leave the euro and rejoin from a much stronger position later.**

References

- Otmar Issing "Europe: Political Union Through Common Money" London: IEA Occasional Paper 98, 1996
- Interview: Otmar Issing, *Central Banking*, XXVII (2), November 2016 pp. 38-9

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