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

Jan Kregel
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.
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.
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.”
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.”
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.
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

- Interview: Otmar Issing, *Central Banking*, XXVII (2), November 2016 pp. 38-9
www.levyinstitute.org

Thank You