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Maastricht 2.0

Alternatives for monetary union beyond the centralization fetish

Heribert Dieter

The continuing financial crisis in some member countries of the eurozone has intensified the debate about reforms of the monetary union. It is obvious that the original architecture of the Treaty of Maastricht has to be revised. The two alternatives suggested by the proponents of deeper integration – either deeper integration regarding monetary and fiscal policy, or a return to antagonistic, national policies – are far from being inevitable. By contrast, it is possible to make the monetary union more crisis-proof while at the same time giving the European nations a high degree of responsibility for their own economic development. The frequently cited assertion that transferring – i.e., centralizing – hitherto national competencies to the European level would make fiscal policy and financial regulation easier to manage does not convince. That approach ignores the downside of centralization. Far-reaching centralization may result in new problems and will weaken, not strengthen, the economic dynamism of the EU.

For 30 months now the eurozone has been agonizing over a financial crisis that has its origins in some of the member countries. But the crisis has lingered on and there has been no return to steady growth. This situation has led to urgent demands for a quick solution to end the crisis by creating new, deeper forms of cooperation in the eurozone. Proponents of this line of thinking argue that cooperation in Europe can only succeed by immediately creating a fiscal or banking union. However, alternatives do exist. An evolution of the Treaty of Maastricht is possible and would better serve the heterogeneity of the EU than a centralization of economic policies, which would inevitably result in a reduction of sovereignty for the European nation-states. Furthermore, the current distress is preventing a calm debate about the utility and risks of further integration in the member countries.

One factor that has contributed to this highly unsettled atmosphere is the neglect of positive developments from both the financial markets as well as policymakers. For instance, according to OECD data, the eurozone ranks high regarding fiscal policy in 2012. The OECD expects budget deficits of the eurozone countries to be 3 percent of GDP on average, whereas the United States will have a deficit of 8.3 percent of GDP –

PD Dr. Heribert Dieter is an Associate in SWP's Global Issues division

almost three times that of the eurozone. Japan (−9.9 %) and the United Kingdom (−7.7 %) also have much greater problems regarding budget deficits than the eurozone as a group.

Systematic pessimism?

The success of the reforms in the countries affected by crises – with the exception of Greece – does not warrant the pessimistic evaluations of these economies. Of course, the economic crises of these economies in Europe will not be solved overnight. The reduction of public debt that has been accumulated over decades will require patience and needs time – as was the case with the successful reforms of the formerly overly regulated labor markets. It was a mistake on the part of those managing the European crisis to create the impression that quick solutions would be available. Furthermore, it is naïve to expect a sudden jump in employment once labor market reforms have been implemented, for instance in Spain. In Germany, in particular, it is well known that there is a long lag, often years, between the implementation of reforms and the rise of employment. Amidst a deep crisis, companies are reluctant to hire new staff.

In the eurozone, positive developments are not limited to fiscal policies. All crisis countries have reduced their current account deficits, often drastically. Spain, for example, lowered its current account deficit from 9.6 percent of GDP in 2008 to 0.9 percent of GDP in 2012. In addition, countries like Italy and Spain have not been excluded from capital markets, as some alarmist observers have suggested. Both countries have been able to refinance their maturing debt – albeit at higher interest rates than before – and bond auctions have usually been oversubscribed.

Today, interest payments on public debt are much less of a burden for the Italian economy than before the country entered the eurozone. Debt service currently represents less than 5 percent of GDP, whereas in the mid-1990s interest payments on public debt cost more than 10 percent of GDP. Why are these comparatively positive developments not appropriately acknowledged, even by leading politicians in the affected southern European societies?

A possible explanation for this willful ignorance is the desire for ever-deeper integration in Europe. The transfer of competencies in fiscal policy is offered as a solution for today's economic malaise. Of course, these proposals ignore the fact that without monetary integration, some of the calamities – of, say, Greece – would not have happened in the first place. The liberalization of capital flows and the creation of rather identical interest rate levels have contributed to the erroneous trends in Greece, Spain, and other economies in the eurozone.

Whether or not the centralization of certain policies – for instance the regulation of financial markets – will be the appropriate reaction to the crisis is hardly discussed. Reducing the sovereignty and power of member countries is considered to be a panacea. Centralization has become a fetish: The creation of supranational structures and procedures is expected to have almost magical effects that will not only enable the eurozone to emerge from the current turmoil, but will also result in a more robust financial sector in the future.

Risks inherent in the transfer of sovereignty to the supranational level

The respected philosopher and sociologist Jürgen Habermas is a prominent supporter of the comprehensive deepening of the EU. In August 2012, Habermas, the economist Peter Bofinger, and a former member of the Federal Cabinet, Julian Nida-Rümelin, called for more integration in the EU. Only by "significantly deepening integration" could the common currency be rescued. Without the transfer of sovereignty to the supranational body, a "never-ending chain of rescue operations" will challenge the

solidarity of the European peoples. Habermas et al. suggest a bipolar position and argue that "only two coherent strategies for overcoming the crisis" exist – deeper integration or the collapse of the eurozone. The goal of the integration process shall be "to regain the capacity to act against the imperatives of the markets at the transnational level."

However, the arguments of Habermas et al. are not convincing. Policymakers will not be able to emancipate themselves from the pressures created by financial markets through deeper European integration. If Habermas et al. want to successfully regulate financial markets and are worried that national regulation is skirted, regulation at the European level will not be sufficient. Instead, it would be necessary to implement more comprehensive regulations at the global level – for instance within the G-20. Today's unregulated capital flows would enable market participants to avoid unpleasant re-regulation in Europe. Unless capital flows are restricted, governments cannot regain authority over financial markets simply by Europeanizing regulation.

In Europe – in particular in countries in the southern periphery – the idea of bypassing markets when setting interest rates has been enjoying a lot of support. With the support of the President of the European Central Bank (ECB), Mario Draghi, policymakers have argued that high interest-rate differentials in the eurozone – both for government debt and for private investment – are an expression of the failure of financial markets. Within Europe – according to this line of thinking – interest rates may diverge only marginally. However, this argumentation is not coherent. It ignores the entirely rational reaction by markets following the first default within the eurozone by Greece earlier this year: Since a precedent has been established, it would be foolish to exclude further defaults. Investors – quite rightly – are demanding a (rather modest) premium for lending to Spain and Italy.

Even more worrying is the implicit logic of the new policy of the ECB, announced by Mario Draghi on September 6. Near identical interest rates are defined as the norm in the eurozone, and the public servants at the ECB claim to know better than the market as to which interest rate levels are appropriate and which are not. The ECB is transforming the eurozone into a command economy in monetary policy. This policy change violates both the spirit and the letter of the Treaty on the functioning of the European Union. The ECB does not have a mandate for setting uniform interest rates.

This new policy change of the ECB that calls for a quantitatively unlimited intervention in secondary markets for government bonds represents a dramatic escalation in ECB policy. This policy change was decided by a small group of appointed civil servants who have taken monetary policy in the eurozone to a new level. The market-based system has been partially undermined. Market-based processes have been replaced by administrative decisions. The claim for upper ceilings for interest rates – raised in the days before the September 6 announcement – demonstrates the kind of economic philosophy that will drive European monetary policy in the future. When the interest levels set by planners are exceeded on the markets, the ECB will buy bonds on secondary markets, including recently issued ones. The ECB would thus drive interest rates down. While primary issues would not be subject to ECB interventions, it is obvious that interest rates on primary markets are not set separately from the levels on secondary markets. An ECB that sets the interest rate level for states mutates into a central planning agency of the eurozone. Technocrats would be setting interest rate levels and signals from the market would be deemed distorted, malfunctioning, or inappropriate. The market economy would be quietly silenced by the ECB.

There has not been an open debate on this matter, either in the EU parliament or

in the national parliaments of the member countries. The ECB has landed a quiet coup. The majority in the Council of the ECB has ignored the concerns of the Bundesbank and has decided to buy unlimited amounts of public bonds of countries in crisis on the condition that they agree to implement certain reforms. Even if it is assumed that the current situation is sufficiently severe to warrant an ECB intervention, it has to be asked how the ECB can possibly end the vicious cycle of market intervention. Once the central bank has begun to meddle with fiscal policy and has started to manipulate interest rates, expectations about future conditions for government finances will be raised. Societies will remind the ECB of the explanation of their 2012 decision and demand to be sheltered from high interest rates that markets demand. Without a severe crisis – e.g. a dramatic rise in inflation – the ECB will find itself constrained by those expectations. It will become hostage to its own misguided decisions.

There is ample evidence of difficulties in implementing agreed reform measures. Crisis management so far has resulted in two countries – Ireland and Portugal – having implemented the agreed conditions. Greece, however, has failed to implement essential parts of the reform program, like the privatization of state-owned enterprises. Thus far, Greece has not been confronted with harsh consequences. It appears that eurozone countries have lost their ability to enforce contract fulfillment and compliance. In other words, in the case of non-adherence to the agreed reform program, the refusal of further payments has not been enforced in the past weeks by European leaders. The creditors of Greece have lost the capacity to act.

The recent decision by the ECB will exacerbate the problem of blackmail. For instance, the ECB will not be able to put pressure on Italy if it has large amounts of Italian government bonds on its balance sheet. Once it has begun, exiting a support program for Italy would be very costly. The ECB would have to write off huge sums if it decided to end its support. The fear is that the model of Greece, not Ireland, will become the norm. The ECB's policy change results in the collectivization of risks without the ability to put severe pressure on individual member states. The ECB has made a dangerous bet on the successful implementation of reforms.

The creation of new, supranational structures will probably not be conducive to solving fiscal and economic problems of some European economies. In any case, it is unrealistic to expect a higher degree of financial stability through centralization – for instance, European supervision of the financial sector. Economic and financial history demonstrates this very clearly. Supporters of centralized financial supervision have to explain why the United States slipped into the financial crisis of 2008, which was the worst since the 1930s. Even newly established supranational regimes of banking supervision have not prevented serious crises. Even the banking supervision policy packages of Basel I and Basel II have not prevented numerous crises in the last three decades. Supranational rules failed in Mexico in 1994/95, during the Asian crisis 1997/98, as well as during the US subprime crisis of 2007/08 – to name just a few. Therefore, it is entirely appropriate to be skeptical about supposedly sweeping and promising solutions. Centralized supervision is not immune to making the same mistakes as national authorities.

Furthermore, the relatively technical-sounding process of creating a European Banking Supervision is also a very political process. Besides formulating particular rules, the banking supervision also has to implement them. This implies that failing banks must be shut down – never an easy job, and one that can create significant resentment. Politically, expropriating shareholders is a difficult task that supranational authorities will probably be reluctant to implement. It is the task of a sovereign state. Before transferring this power to a supranational authority, some constitutional issues must be clarified.

Moreover, it is not clear what improvements can be expected from a centralized supervision of the financial sector. Assume a scenario in which real estate prices have grown rapidly in the last decade in Spain and a credit glut has developed. The European regulator has identified the problem, but what tools does it have at its disposal? Would it have more options than the national Spanish banking supervision in case of a regional credit boom that funded an emerging housing bubble?

The simple answer is that a centralized authority is not better positioned to prevent price bubbles if they occur regionally. If the future European Banking Supervision were to tighten the conditions for lending to a particular market, it would immediately create opportunities for arbitrage. Then, Spanish property buyers could finance their real estate through banks outside of Spain. If they were to get credit from other banks within the eurozone, this could be done without exchange rate risk. If the European banking supervision were to try and prevent this, it would have to restrict the conditions of mortgage loans in the whole eurozone. The collateral damage of such an approach would be enormous and would be a significant burden on European citizens. Loans would become more expensive in the eurozone. It seems unrealistic to expect such an ECB policy.

An excess of caution?

Of course, the disadvantages of centralized financial regulation are not limited to the prevention of future crises. It is also possible that Europe's further economic development would be restricted by an overly restrictive policy. Funding would become much more expensive than it is today if supranational regulators were to take a very cautious approach.

Especially for the German economy, this point is very important. The German financial system, which is characterized by three pillars – private banks, credit unions, and saving banks – in the past financed investments of medium-sized companies at relatively favorable conditions. In particular before the creation of the euro, competitors from southern European states always criticized these conditions as being an inappropriate and unfair competitive advantage of their German peers. The higher financing and investment costs in the south, particularly before the introduction of the monetary union, made it harder – so they argued – to compete.

Especially German credit unions and saving banks would suffer from the European Commission's advocacy for the centralization of banking supervision. The current competitive advantage of these banks and their customers would probably disappear through overly strict supervision. The main beneficiaries of centralization would be large international banks, which of course represent a much greater threat to financial stability than credit unions and savings banks.

Cornerstones of Maastricht 2.0

After considering the risks inherent in further integration, the question is whether there are any alternatives. It is clear, of course, that there are: Europe can evolve without a great leap forward, which is rejected by a sizable number of citizens in the eurozone, where support for integration varies considerably between countries. One should not forget that the Maastricht Treaty offers several advantages, many of which are worth preserving. The common currency reduces transaction costs within the eurozone without forcing the participating countries into a centrally planned fiscal policy straightjacket. This approach acknowledges the diversity of European societies much better than a one-size-fits-all concept.

In contrast to the bipolar view favored by the advocates of centralization, there are more than two alternatives for the future development of the eurozone. There is not only a choice between "more Europe" and "monetary nationalism" (Habermas).

Europe can both strengthen the ownership of economic and fiscal policies by individual societies as well as provide incentives for sustainable economic development. The key factor is the elimination of contradictions and inconsistencies of the Maastricht Treaty. The six most important points are:

(1) There is a contradiction between the no-bailout clause (Article 125, Treaty on the Functioning of the European Union) and the absence of an exit option. This regulatory gap has been successfully exploited by Greece. To prevent a recurrence, the Treaty of Maastricht should be supplemented by an exclusion clause: Member states that do not fully service their payment obligations have to leave the monetary union within six months after the default.

This amendment would leave the responsibility for sustainable fiscal policy where it belongs: in the member countries of the eurozone. The potential loss of economic benefits of membership in the monetary union would offer a sufficient incentive to implement a sustainable fiscal policy. The amendment would also send a signal to financial markets. Monetary cooperation is not independent of the fiscal policies in the member countries. Risks differ. The undesirable developments prior to 2008 – when markets did not distinguish appropriately between individual countries and demanded relatively uniform interest rates – will not reoccur.

(2) States should be able to leave the eurozone, if they consider the benefits of membership to be lower than the costs. A monetary union does not have to act as a custodian for societies and impose certain and everlasting monetary and exchange rate policies on them. Because of the current compulsory membership, the monetary union also ceases to be attractive both to members and non-members.

While the forced exclusion of countries that default would have a disciplining effect on individual states, the option of withdrawal has a disciplining effect on the group. Consequently, the introduction of asymmetric discrimination mechanisms is more difficult. No member state would leave the eurozone for frivolous reasons, but in principle this option should be created. It should also be possible that societies can change their preferences. Therefore, the institutional framework of the eurozone should be able to accept democratic decisions taken in the member states. The absence of options and the use of rhetoric that promotes doomsday scenarios concerning hypothetical exits results in resentment, not in continuing support for the European integration process among peoples in the monetary union. The European integration process will not remain a matter of the heart if it is portrayed as being prearranged and containing no alternatives.

(3) Individual countries should be permitted to protect themselves against unwanted capital inflows. The prevailing doctrine – only unrestricted capital flows ensure rising prosperity – has to be called into question after recent experiences. Temporary restrictions on capital inflows may enable individual economies to curb excesses in the markets and to shield an economy from their negative effects.

Today, countries are not allowed to limit capital flows within the European Union. Article 63 of the Treaty on the Functioning of the European Union prohibits any restrictions. Capital flows thus enjoy the same protection as trade in goods and services or the unrestricted movement of labor. But treating capital flows and goods equally is questionable. In the past, capital flowed within the eurozone from countries with current account surpluses – like Germany – to countries with current account deficits, namely today's crisis countries. Economies could not protect themselves against an inflow of hot money. In Spain and Ireland, the inflows fuelled existing property booms. There are numerous examples in financial history that demonstrate the risks associated with large current account deficits. These are reliable indicators for the potential emergence of a debt crisis. This was the case in the Latin

American crisis of the early 1980s as well as in the 1997/98 Asian crisis, in addition to the crises in the United States, Iceland, Ireland, Spain, and Greece. Therefore, temporary restrictions on capital flows could help to protect economies against "irrational exuberance." The International Monetary Fund, which was hostile towards restrictions on capital flows for decades, acknowledged this in 2010 and has since been advocating the utility of temporary restrictions of inflows. The exact shape of these instruments – whether taxes or reserve requirements – is of secondary importance. Examples are the taxation of inflows applied in Brazil since 2009 and the reserve requirements Chile demanded in the 1990s.

(4) The European Central Bank is the lender of last resort for the financial sector in the eurozone. But in the future, the provision of liquidity in times of crises should only be allowed under strict conditions. The ECB should provide emergency liquidity generously, but only at penalty rates and against good collateral. In the crisis management applied so far, the ECB has directly subsidized the financial sector. By doing that, the ECB has contributed to the continuation of non-sustainable policies.

In the future, the ECB should grant emergency loans at interest rates that are lower than market rates, but not as low as they have been recently. The ECB should calculate the average rates of the three worst-performing sovereign debtors in the eurozone and use that level to determine the interest rate it charges.

Of course, every financial system needs a lender of last resort that is able to provide liquidity even when the markets are spooked. In case of a panic on the markets, the absence of a lender of last resort can lead to a serious financial crisis. But that lender of last resort has to require conditions for its loans: Liquidity is provided only against good collateral and at high interest rates. The ECB has violated both conditions many times.

The subsidization of the financial sector by the ECB is even more alarming. Banks were able to borrow from the ECB at an interest rate set close to zero. Using that liquidity to buy Spanish or Italian government bonds with relatively high interest rates was a fabulous investment. Nominal returns of 5 percent or more were the norm. The ECB does not have a mandate for this subsidization of the financial industry. It is also not the job of the ECB to keep so-called zombie banks alive by providing hidden subsidies.

Setting an appropriate interest rate level for emergency loans is of course not easy. It should be lower than the prevailing market rate but high enough to deter excessive use of the facility. One possibility would be to require the ECB to use an average of the rates that the three lowest-ranked countries in the eurozone have to pay for primary issues.

(5) The European Central Bank has to be placed under a stricter and more direct supervision by democratically elected politicians. The independence of central banks was initially granted in order to enable them to provide their core product – monetary stability. A lack of political control of the ECB is no longer tolerable, at least since the announcement of September 6, which will result in the ECB becoming a player in fiscal policy. The ECB needs a supervising board that could be composed of members of the national budget committees and the European Parliament.

The ECB has been purchasing government bonds over the last years and has thus accumulated significant risk in its books. On September 6, President Draghi announced that the ECB may intervene in secondary markets with "unlimited amounts of money." Of course, that operation will not be free of risk for national budgets. Besides the fact that the approach should be evaluated by the European Court of Justice, there ought to be regulatory consequences for the ECB. The ECB does not have a mandate for financing governments, neither direct nor indirectly. The ECB will be accepting a lot of potentially risky bonds on its books. Should a member country

default, some of the nominal value would have to be written off and the member countries of the monetary union would be liable. Therefore, the independence of the ECB will have to be limited as long as the central bank remains an active player in fiscal policy.

A possible solution would be to form a committee composed of members of national parliaments that would approve the ECB's measures. In this committee, the member countries of the eurozone should be represented according to their exposure to risk. Furthermore, this supervising board should also have the ability to dismiss particular members of the ECB Governing Council before the end of their terms. This should be the case if the majority of the supervising board considers the respective member of the Governing Council to have failed at its job. Unlike today, the council members would be accountable to democratically elected politicians.

(6) Crisis management has put more emphasis on national ownership. Supranational solutions should only be considered as a last resort. Stumbling banks should receive European support only when all national efforts for stabilizing that institute have failed. Those handling European crisis management should overcome their fears about nationalizing or closing commercial banks that cannot survive in the market place. To prevent the premature activation of supranational mechanisms, the full nationalization of a bank should become the precondition for any European support program.

At least in some cases, one gets the impression that policymakers in some countries of the eurozone carefully evaluate the political costs of different approaches: Often, they do not choose the most appropriate solution, but rather choose the path that has the lowest political costs. An example is the large Spanish conglomerate Bankia, for which the Spanish government had requested help from other European states before fully exploiting its own toolbox. Bankia has not been fully nationalized. If the primarily Spanish shareholders were to write off their complete investment, the political damage would probably be substantial.

The two main categories essential for an efficient market economy – risk and accountability – have to be reintroduced in the eurozone. Currently, Europe is being weakened by misplaced rhetoric that puts too much emphasis on rescuing the financial sector. Bailing out banks that cannot compete is creating moral hazard and will result in a feeble – not a strong – Europe. Europe should depart from a system in which taxpayers bear the risk while financial markets are protected against the consequences of their own activities.

Europe 2020 – Centralized planned economy or return to national ownership?

In the financial crisis, Europe has been stumbling toward an economic system that is reminiscent of a planned economy. The mechanisms of the market have the potential to be deactivated permanently while a weakly legitimized institution – the European Central Bank – is being endowed with far-reaching and inconceivable powers. The creeping disempowerment of national governments and parliaments by the ECB is alarming from a (German) constitutional perspective, and it should lead to the further strengthening of Euro-critical assessments. The author Hans Magnus Enzensberger has described this process as the disenfranchisement of the European citizen and has insistently warned about this risk.

But there are alternatives for European integration. A revised treaty – Maastricht 2.0 – should aim at minimizing the transfers of sovereignty to the supranational level, insist on the compliance of contracts, and strengthen national ownership of economic policies in the member countries of the European Union.

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SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3–4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

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