The key to reform of European Economic and Monetary Union (EMU) lies in an intelligent balance between an autonomously implemented but collectively coordinated economic policy, on the one hand, and the need for some degree of centralization, on the other.

European economic government should be established, consisting of a preventive and a reactive branch. For preventive purposes, the member states should coordinate their decentralised economic policies, with the aim of avoiding macroeconomic imbalances. Only if this fails would reactive instruments – centrally controlled – kick in.

Notwithstanding the analyses of the Van Rompuy Task Force, the European Commission and the German government, a lack of budgetary discipline is not the decisive cause of the current crisis in the Eurozone.

A return of European economic policy to the goals of the so-called »Magic Square« (Magisches Viereck) is long overdue. Furthermore, workers should get their proper share of Germany’s export success, reversing the pursuit of lower unit wage costs. There should also be a number of institutional innovations, such as the establishment of a Community Budget Committee of national parliaments.
Content

1. Balance between Decentralised and Centralised Economic Policy ................. 3

2. Broadening of EMU to a European Economic Government ....................... 3
   2.1 The Preventive Branch of European Economic Government .................. 4
   2.2 The Reactive Arm of European Economic Government .......................... 8

3. Summary ........................................................................................................ 9

Further Reading .................................................................................................. 10
1. Balance between Decentralised and Centralised Economic Policy

The current debate on the form of a European economic government is rather incoherent. Numerous reform proposals concentrate on correcting individual shortcomings – an overall approach which encompasses the elimination of macroeconomic imbalances, ensuring well-functioning financial markets and consolidated budgets equally is barely being discussed. The main focus is on proposals to enhance the sanctions available under the Stability and Growth Pact – one might mention the Van Rompuy Task Force, the European Commission and the German government in this connection – on the assumption that the lack of budgetary discipline is the decisive cause of the current sovereign debt crisis. In some quarters, it is true, the need for greater economic policy coordination has been mentioned. Also still unresolved, besides the selection of which member states would be involved – Eurozone vs EU27 – is what the scope of such coordination would be and what economic policy parameters would be included. Furthermore, Germany’s contribution to the crisis in the form of its export-oriented economic policy is seldom discussed, although this is a fundamental driver of macroeconomic imbalances within Europe.

The key to reform of European Monetary Union (EMU) lies in striking an intelligent balance between autonomously implemented, but collectively coordinated economic policy, on the one hand, and the need for some degree of centralisation, on the other. It is not a matter of the unconditional transfer of additional decision-making competences to a central European economic government. The aim must be to moderate the tensions existing between heterogeneous macroeconomic development and increasing economic interdependence in such a way that the current difficulties with regard to balance of payments and national budgets are reduced. Only when the euro-members coordinate their economic policies with a view to developing compatible economic structures, living standards and economic policy priorities can a common currency function properly and macroeconomic imbalances be avoided. In addition, effective measures must taken at the European level to regulate financial markets in order to lay the foundations for properly functioning financial markets and to direct the deployment of mobile capital along channels in which it is used not for speculation but for the purposes of the real economy. Finally, EMU must also lay the foundations for credible budget consolidation so that in future states will not be constrained in taking appropriate action and the debts of one country cannot be offloaded onto another.

2. Broadening of EMU to a European Economic Government

The concept of European economic government presented here consists of the combination of a preventive branch, with which the member states coordinate their decentralised economic policies with the aim of preventing the emergence of macroeconomic imbalances, and a reactive branch, which is centrally controlled and corrects imbalances. European economic government is thus effected on two levels, with competences being divided between member states and the EU. What is advocated here, therefore, is to be distinguished from the idea of a centralised European economic government within the framework of which the European Commission works out the basic outlines of economic policy and lays down the parameters of state budgets.

The idea behind a preventive branch is, based on the principle of subsidiarity, to endorse economic policies determined autonomously by the member states but to provide a framework for them, in the form of an obligation to coordinate policy with central macroeconomic parameters and stability criteria backed by sanctions, by means of which any negative effects of national economic policies on other member states will be minimised. As long as the decentralised coordination undertaken autonomously by member states functions properly and no macroeconomic imbalances emerge, there is no need for central control and corrective measures at the EU level – the decentralised coordination mechanism can render central control unnecessary. Centrally imposed measures become necessary only if the preventive coordination and stability mechanism is no longer sufficient to curb the negative externalities of national economic policy or to deal with crisis situations caused by imbalances within the Eurozone. In this case, effective and centrally implemented correction is required, justified on the grounds of the negative cross-border effects of national economic policy. A centralised economic government is therefore only reactive in nature and for the purpose of limiting and reducing imbalances.
2.1 The Preventive Branch of European Economic Government

Coordination of Tax and Wage Policy Parameters

In order to avoid significant discrepancies with regard to economic cycles within the Eurozone central parameters of national economic policy which influence these cycles should be coordinated.

As Germany’s export policy in recent years illustrates, wage policy in particular is used as a lever to improve national economic competitiveness. In addition, Germany has used corporate taxation as an instrument to boost competitiveness. Take out wage and tax dumping as tools for improving competitiveness and governments and companies will be forced to ensure their competitiveness by other means, in particular innovation, research and development, and investment incentives.

Coordination of wage and tax policy can cushion regional boom-and-bust cycles, prevent diverging macroeconomic developments, curb current account imbalances and reduce sovereign debt. In this way, automatic and preventive stabilisers would be put in place, thereby minimising the need for regular discretionary transfers within the Euro group from the outset.

In order to prevent tax dumping uniform minimum rates and bases of assessment for corporate tax would make sense. This is the only way of avoiding that some countries ensure market share at the expense of other member states. Mario Monti’s recent report on the Single Market also makes the case for closer coordination of corporate taxation, seeing it as a way of preventing tax arbitrage. Besides corporate taxes, coordination should also extend to taxes which represent an input for industrial production, as in the case of energy taxation. Here closer coordination could help to diminish the use of national tax policy as an instrument for controlling competitiveness.

A coordinated wage policy would also be necessary to lay down a Europe-wide mandatory target for wage development – while preserving free collective bargaining – which would be applied equally in public and private wage negotiations. Nominal wages should be orientated in accordance with the sum of productivity gains and national inflation. This rule means no more than that no country should live beyond – or below – its means. Indispensable for the coordination of national wage policies in the EU is the institutional and organisational Europeanisation of social partner associations. Because of free collective bargaining, the state in Germany does not have direct access to private sector wage determination. However, incentives to comply with the principle of productivity-oriented wage increases could be established. The awarding of public contracts could be made dependent on compliance with this regulation, with the inclusion of a compliance criterion in accordance with which nominal wage development in comparison to productivity is taken into account. From an institutional standpoint, wage and tax policy coordination should utilise the existing framework of the Macroeconomic Dialogue. This serves as a communication forum for the actors involved in monetary, wage and fiscal policy and brings representatives of the Council, the Commission, the European Central Bank, the trade unions and the employers to the same table.

Underpinning this there must be an EU-wide common minimum wage. Twenty out of the 27 EU member states already have a statutory minimum wage. Experience shows that countries with a minimum wage, on average, exhibit higher domestic demand and higher GDP. In future, all member states must have a minimum wage, which should be at least 50 per cent of the national average gross hourly earnings in order to prevent unfair wage dumping at the expense of the low-wage sector.

Adaptation of the Stability and Growth Pact to Establish Balance of Payments Equilibrium

To prevent macroeconomic imbalances in good time a target figure for the foreign trade balance should be integrated into the Stability and Growth Pact alongside sovereign debt, in order that the available sanctions are applied in accordance with the Pact. A return to the aims of the Magic Square can be discerned in this, which were anchored in the German Stability Act as early as 1967. The goal of a balanced foreign trade contribution in this way has equal status with the goals of steady and adequate economic growth, price stability and a high

1. A term relating to economic policy which has its origin in the Stability Act of 1967. It signifies the four main aims towards which the economic policy of the Federal Government and the Länder should be directed: price stability, a high level of employment, balance of payments equilibrium, and steady and adequate economic growth. The equal status of all four aims in the context of economic and fiscal policy led to their being dubbed the »magic square«.
level of employment. By balance of payments equilibrium is meant the avoidance of continual current account deficits or surpluses.

In order to ensure a balance of payments equilibrium no Euro-member should be permitted to register a current account imbalance of more than 3 per cent for intra-EU trade, whether deficit or surplus. In that way, the current spillover effects of competitive countries such as Germany at the expense of deficit countries – and vice versa – would be reduced. At the same time, it is up to each individual country what economic policy measures it takes to ensure balance of payments equilibrium. One of the main advantages of setting a target of balance of payments equilibrium would be that member states' freedom is preserved with regard to how they achieve the target of current account balance. Encroachment upon member states’ competences by the specification of certain economic policy measures could be avoided. At the same time, Euro-members would be obliged to engage in at least a minimum level of economic policy coordination in order to preserve balance of payments equilibrium to ensure that their economic measures do not lead to imbalances in relation to other Euro-members.

A key measure for reducing existing foreign trade imbalances is a reversal of the unit wage cost approach. Although in the medium term, a productivity-oriented wage policy is to be pursued, in the short term wage agreements significantly above productivity growth should be the goal. Germany needs sharp increases in unit wage costs more than its EMU partners, the Southern European countries, need below average wage costs. The objection of resulting inflation risk does not apply. In recent years, Germany has usually fallen well short of the ECB’s inflation target. In future, on the basis of EU-wide budget consolidation deflationary pressure is even likely. As a result, wage increases would help to reduce Germany’s high current account surpluses. The intention behind high wage agreements is not that Germany lose its export strength but that workers may benefit from strong exports over the long term. Stagnating real wages, together with constantly rising exports, weakens domestic demand, causes EU-wide imbalances and begets inflationary tendencies.

Budget Consolidation within the Framework of a Reformed Stability Pact

Budget consolidation within the EU is needed if future fiscal policy leeway is to be maintained, interest rates are not to rise too high and curb the propensity to invest, the financial markets are not to become the target of speculation and there is to be no incentive to engage in debt reduction via inflation.

Contrary to general belief, the pressure exerted by the Stability and Growth Pact for budget consolidation is real. Between 1998 and 2008, public debt fell in the Eurozone from an average of 73 per cent of GDP to 69.4 per cent. Nevertheless, it is clear that, against this trend, some states have accumulated significant debt levels (France, Greece, Hungary, Portugal and the UK).

Against this background, a stepping up of sanctions is not the way forward, as the European Commission and the Van Rompuy proposals foresee, under which, even below the current Stability and Growth Pact thresholds, sanctions can kick in under certain circumstances. The need for a sanction procedure oriented towards budget consolidation must not lead to a diminution of member states’ economic policy leeway. Therefore, also those proposals which, in the case of a significant breach of the 60 per cent (of GDP) limit on the national debt, regard as permissible only a much lower budget deficit of 3 per cent are to be rejected. An anti-cyclical budgetary policy must continue to be possible, notwithstanding the commitment to consolidation. Because even in a downturn countries must retain the possibility to increase public ex-
penditure in order to boost the economy. The current
debt criteria should therefore not be applied rigidly, but
be adaptable to the economic situation.

Although a tightening of the sanction criteria is not,
therefore, advisable, the development of the deficit
countries and the attendant destabilising effects for the
Eurozone show that reform is needed, aimed at improv-
ing institutional conditions, automatic application of the
deficit procedure, and preventive control of budget legis-
lation.

In institutional terms, the roles shared hitherto by the
Commission and the Council within the framework of
the Stability and Growth Pact must be redesigned. The
current division of functions is not fit for purpose: the
Council, as representative of the member states’ inter-
est, cannot convincingly assume the role of watchdog
when the deficit rules have been, as now, extensively
breached. Since 25 out of the 27 EU member states are
already violating the Stability and Growth Pact criteria it
is only to be expected that a large proportion of member
states have a primary interest in remaining exempt from
Stability and Growth Pact sanctions. On the other hand,
care must be taken that, in light of the sanction infringe-
ments in national fiscal policies the greatest possible
legitimation of sanctions should be ensured. For that rea-
son, the European Parliament should participate in the
deficit procedure. That means, in a first stage, greater
transparency on the part of the Commission in relation
to the Parliament in the matter of ongoing deficit pro-
cedures. Down the road, the Parliament should take over
the role currently performed by the Council in decision-
making on the imposition of sanctions. In order to meet
the need for the highest possible automation in the san-
cctions procedure a »negative« requirement of approval on
the part of the European Parliament should replace the
customary approval requirement. On this basis, a sac-
cion provided for in the Stability and Growth Pact and
proposed by the Commission would only not be applied
if a majority in the European Parliament voted against
taking sanctions.

An automated procedure of this kind, under which sac-
cions would kick in with no need to obtain the discretion-
ary assent of the Council, as hitherto, could further en-
hance the Stability and Growth Pact’s consolidation in-
centives. At the same time, it would ensure that the
remaining discretionary element in the application of
sanctions would be lodged with the directly legitimate
European Parliament. The Commission’s discretionary
powers in the application of sanctions would be re-
stricted because the individual steps of the deficit pro-
cedure would already be specified by the basic stipu-
lations of the Stability and Growth Pact. Although a pro-
cedure based on positive incentives is fundamentally to
be preferred to a deficit procedure underpinned by sanc-
tions, such an incentive procedure would tie the achiev-
ment of specified criteria to the granting of certain
benefits which would be denied to countries in violation.
In any case, at present it is not clear what such an incen-
tive mechanism should look like if it is to be capable of
bringing about budget consolidation.

Besides greater automation of the sanction procedure
sanctions must in future be so designed that they do not
exacerbate a crisis. Central in this respect is a change in
the form of the available sanctions. The existing sanction
depositing an interest-free sum with the Community
which can be converted into a fine is counterproductive
and aggravates the country’s problems. Alternative ways
of stepping up sanctions include:

- Delayed payment of Community funds to the member
  state in question.

- A coordinated sanction procedure through the con-
certation of the Commission, the financial supervision for
  credit institutions and the ECB. In order to provide a
  greater incentive to comply with the Commission’s rec-
  ommendations on budget consolidation the financial
  supervision for credit institutions must stipulate the main-
  tenance of higher capital buffers for the government
  bonds of countries which do not comply with the recom-
  mendations. Alternatively, it could be stipulated that the
  ECB accept the government bonds of these countries as
  security for its loans to commercial banks only at a dis-
  count, the discount being determined in proportion to
  the seriousness of the violation of the Stability and
  Growth Pact.

- The curtailment of voting rights (temporary halving of
  the weight of their votes) in the ECOFIN Council, al-
  though not in other Council permutations so that sanc-
  tions are imposed only where EMU is concerned.

An early warning mechanism in accordance with which
EU governments could present their draft budgets to
other member states for their perusal within the framework of a member state coordinated procedure makes sense in certain circumstances. Since budget legislation concerns what was originally the competence of national parliaments, budget assessment should also be under the control of national parliaments. Only in this way can the highest level of legitimacy be ensured. A Community Budget Committee should be set up composed of representatives of national parliaments and tasked with evaluating draft national budgets. This budget committee could deliver non-binding comments on what it thinks needs changing in the budget. The representative of the country with the budget under examination would have no voting rights. Such an early warning system would have the advantage that assessment would revert to purely member state coordination, it would not be linked to any sanctions, the participation of the Commission would be dispensable and, for example, in Germany, there would be no infringement of the budget sovereignty granted the Bundestag by the Constitution.

Effective Financial Market Regulation in order to Avoid Currency Crises

Market reactions to the Greek crisis only served to make things worse and reinforced the fluctuations in the yields of government bonds in some Eurozone members, regardless of the underlying economic reality. As already in the financial crisis, transactions on capital markets became detached from the development of the real economy and took on a life of their own, beyond the control of the affected states.

The existing macroeconomic imbalances in the EU have been exacerbated by unregulated financial markets. They have therefore acted like an accelerant: the situation of the deficit countries, as difficult as it was, was considerably worsened by speculation. The extent of the sovereign debt crisis was increased by financial market speculation. Clearly, therefore, measures aimed at eliminating macroeconomic imbalances must be underpinned by effective financial market regulation. Macroeconomic equilibrium free from capital market distortions is conditional on properly functioning financial markets.

The reform measures introduced since the outbreak of the financial crisis are inadequate. The aim of harnessing the financial markets to the needs of the real economy has not yet been achieved. A financial transaction tax is still key. If tax evasion is to be avoided taxation must be extended to cover all financial transactions, including derivatives. Such a tax would be levied on securities and derivatives transactions, if carried out in the EU or, if abroad, with the participation of at least one EU firm. The tax could take the form of a general and modest imposition on all transactions involving financial securities at a rate of, for example 0.05 to 0.1 per cent on anything above 1,000 euros. Purchases of securities with the intention of holding onto them would scarcely be affected. Also, the more short-term the transaction, the higher the rate. This is because the profitability of short-term speculation derives from the sum of the differences between the purchase and sale price. These differences are narrowed by a financial transaction tax and all the more, the more marginal they are. As a result, short-term speculation with financial derivatives would become considerably more expensive and may therefore be expected to recede. Hand in hand with this the degree of price volatility is also likely to diminish. A bank levy and a financial activity tax can be introduced only as supplements to a financial transaction tax; they do not represent an alternative.

If high-risk transactions by financial institutions are to be restricted capital requirements must be improved, both qualitatively and quantitatively. For this purpose, the Basel II Committee needs to come up with detailed plans on capital ratios, leverage ratios, and anti-cyclical capital buffers.

So far, the member states appear to have been able to thwart the introduction of a European supervisory regime worthy of the name. The European Commission’s proposals which could bestow more far-reaching powers on the new EU authorities, with direct authority for decision-making and the imposition of sanctions with regard to financial institutions, have hitherto been blocked by the member states for fear of a loss of sovereignty. In this context, the location competition between supervisory authorities which was in full swing before the crisis seems set to resume – these authorities will also remain inclined to regulate their own banks more leniently than in neighbouring states in order not to weaken the national financial centre.

A registration office for securities must be set up in order to certify financial products and to attest to their specific benefit for the economy. Every product must be scruti-
nised before it can be traded. A detailed product information sheet – or »user manual« – should present a uniform classification of the security in terms of the risk category it belongs to.

Although rating agencies have been subjected to new regulations by the EU, which have eliminated some abuses (for example, the structuring of products evaluated by them), these agencies are still paid by the companies whose products are being assessed, which establishes a structural dependence and undermines their objectivity and neutrality. The establishment of a European rating agency is long overdue. Only in this way will it be possible to end the market dominance of the three big American rating agencies in favour of a European one which will also take into account overall economic development. A European rating agency should be funded from the revenues raised by the financial transaction tax.

2.2 The Reactive Arm of European Economic Government

Reactive instruments kick in when preventive tools have not done the trick. The aim of the preventive arm of European economic government is to avert the emergence of macroeconomic imbalances by early coordination, sanction-backed stability criteria and regulated financial markets. However, if a situation arises which threatens the whole monetary union, as in the sovereign debt crisis, a set of instruments must be applied which makes possible a rapid and coordinated response based on an institutionalised crisis management mechanism.

A crisis management mechanism is also necessary to avoid exits from the monetary union and state insolvency. Expulsion from the monetary union would have dire consequences, both for the country in question and for the Eurozone. Although exit from EMU would make it possible to reduce high wage costs in foreign currency through devaluation and thereby improve competitiveness and the current account balance it would lead to subsequent insolvency due to more onerous existing euro debt servicing. All debt instruments would be affected by this, both public and private. As a result, the claims of European banks against Greek government bonds and private borrowers in the insolvent state would be devalued, which would shake the financial sector, thereby destabilising the economy as a whole. It would also be right, however, for creditors to be involved in rescue measures in the form of appropriate rescheduling. In any case, rescheduling is possible even without state insolvency (see below).

Politically, the expulsion of a country from the monetary union would spell the beginning of the end for the EU. Other states would get into difficulties, the foundations of the EU would be shaken, the Common Market would be called into question and political and economic integration would come to a standstill. The risk of infection would also be considerable: if a country was expelled from EMU speculators would waste no time seeking out the next target.

Institutionalisation of a European Monetary Fund

Although the preventive arm of European economic government is supposed to prevent situations in which states are no longer able to refinance in the market, precautions must be taken so that, if the worst comes to the worst, the Eurozone does not come a cropper. Given the increasing economic integration and interdependence of the member states a solidarity mechanism must be established which, in the case of major imbalances and emergencies, can compensate. Embattled Euro-states must have more rapid access to bridging loans. In the case of Greece, if the decision on aid had been taken earlier investors would not have had the opportunity to bet on the country’s bankruptcy. The delays which resulted from the hesitation of some politicians allowed speculators to drive up interest rates on government bonds. In addition, the unavailability of a viable crisis plan brings with it the danger that speculation will be extended to other countries. The EU needs a European Monetary Fund (EMF) which, in the event of a crisis, can swiftly make resources available and provide emergency liquidity aid and support. The EMF would thereby contribute to protecting the euro against speculative attack and to monetary stability.

Institutionally, the EMF should be connected up with the Euro-group – in other words, the finance ministers of the Euro-states. It should be given recommendations by an independent steering committee, which should be made up of experts as an economic advisory council. Each national parliament could delegate one expert to the steering committee. The task of the steering committee would
be, in the event of a crisis, to prepare decisions for the European Council. Decisions on disbursements in a crisis would remain at the discretion of the Council, however, although prepared by the steering committee. This takes account of both the need for democratic legitimacy on the part of the EMF and the ability to act swiftly in a crisis.

The resources of the Monetary Fund would come from three different sources: (i) a financial transaction tax levied at national level and channelled to the Community budget, (ii) the issue of Community bonds (Eurobonds) and (iii) payments by the Euro-countries following the IMF model and in accordance with the economic strength of individual member states. Under no circumstances should the funding of the EMF be based on the originator principle, as has sometimes been suggested, in terms of which the penalty payments of deficit countries would be used. This would only serve to significantly exacerbate the procyclical situation and further narrow the financial wiggle-room of countries in difficulties. In the case of the issue of Eurobonds, which would allow individual Euro countries to obtain loans at a uniform interest rate, every country in the Eurozone assumes joint liability for the total volume. The bonds’ credit rating should correspond to the European average. This would represent a major advantage for less stable countries which could issue their bonds via the EU at lower interest rates. There would be disadvantages for stable countries, however, because their credit rating would be adversely affected and they may have to pay higher interest on the bonds they issue themselves. For this reason, the issue of Eurobonds should be an option only within the framework of the EMF and not as a permanent financing apparatus.

The EMF must be set up in such a way that any perverse incentives that might arise from its permanent establishment are minimised. The existence of the institutionalised safety net for deficit states could establish a tendency towards indiscipline. In order to counter such perverse incentives, there should be considerable powers of fiscal policy intervention which can be granted to the steering committee in the case of a payment by the EMF to a member state. The steering committee would work out the conditions which the receiver country would have to fulfil in order to obtain loans. The member state’s fiscal policy leeway would then be restricted and the EMF steering committee would be able to issue specific instructions with regard to budget consolidation as a condition of its approval of the loan.

Furthermore, creditors must participate in all EMF rescue measures. They must relinquish part of their claims in the form of so-called »haircuts«. The rescue measures should not be borne solely by the group of Eurozone countries; those who made high-risk investments should also be involved. In order that there should be no dramatic escalation on the financial markets, as in a case of insolvency, the extent of the haircut should be restricted to a maximum 10 per cent of the amount of the claim. In this way, market participants would have a clear basis of calculation.

3. Summary

The developments which led to the emergence of the current sovereign debt crisis underline the need for the reform of EMU. However, the solution cannot lie in »less Europe« and a reversion to national currencies. On the contrary, in order to ameliorate the current problem of heterogeneous macroeconomic developments, to reduce current account imbalances and to preserve a fully functional common currency the Euro-members must orient their national economies towards compatible economic structures, conditions of prosperity and economic policy priorities.

This calls to mind the formerly espoused »Krönungstheorie« (»coronation theory«), in accordance with which currency union would be possible only after a long process of convergence of national economic and monetary policies and the realisation of political union. Today it is clearer than ever that, in the long term, only political union can establish the political and economic synchronisation between Euro members needed to prevent imbalances within Europe. As the first step towards political union we should aim for the form of economic government proposed here, which, with due regard for member state autonomy, in the first instance would transfer only fiscal policy powers into the EU’s decision-making authority, if member state coordination does not suffice. The minimisation of macroeconomic imbalances in the Eurozone must be based on a preventive apparatus in the form of a credible and expanded Stability and Growth Pact, coordination of central economic policy parameters and regulation of financial markets. A reactive crisis management mechanism in the form of the institutionalisation of an EMF is desirable, whose resources would come, among other things, from an EU-wide financial transaction tax and Euro-bonds.
Further Reading


