The future of euro-area governance

Ulrich Brasche (Draft Dec. 2018) – comments welcome (brasche@th-brandenburg.de)

Diverging visions of the EU

The process of European integration never reached a consensus on finality. Two opposing visions still prevail: An "ever closer Union" leading to United States of Europe versus an inter-governmental alliance of sovereign nation states à la de Gaulle. Treaty by treaty a mixture of those two evolved. Furthermore, the peoples of the EU are divided over sharing risk and resources versus relying on national responsibility and efforts. Burden sharing seems to be acceptable for the latter group if and only if they gain control over political conduct and performance of the first group – this ´conditionality´, however, infringes on national sovereignty and is thus rejected.

Those differences materialise especially, when it comes to money. Re-distribution even at a very low scale, as provided by the EU budget or as foreseen in the Banking Union, is contested by potential donor countries and defended by potential receiving countries. Any new ideas about Euro-area governance are assessed for a change of control over money and re-distributive side effects.

Fiscal governance and Maastricht 1.0

When adopting the common currency, the Euro, the member states forego two powerful tools for influencing the pace of their economies: Monetary policy and exchange rate. Slow growth or even recessions, asymmetric economic shocks and systemic risks in the banking industry no longer can be tamed by a lower prime interest rate, by devaluing the currency or by using the Central Bank as ´Lender of last Resort´. Instead, two other tools are expected to support the economy: Migration of unemployed workers and fiscal policy, i.e. deficit-based spending of the public budget à la Keynes. Since migration was and is low in and between the "old" member states, this option does not exist in reality. National fiscal policy is the only tool at the disposal of each member state.

Deficit spending, however, can be used only if the state is credit worthy in international financial markets – if the debt burden is too high already, the cost of credit will rise to unsustainable levels and the state may become illiquid and in the end bankrupt. One member´s fiscal trouble will spill over into other member states, which might feel obliged to bail out the state in trouble. The expected ´help from friends´ could undermine fiscal discipline and lead to ´moral hazard´.

The Maastricht Treaty (1992) introduced the Euro as a common currency, while fiscal policy remained national. All members promised to limit public deficit and debt and a bail-out by other members was excluded. A supervision of public budgets by the European Commission with fines as last resort was agreed upon. The simple rules of deficit and debt limits (3% resp. 60% of GDP) morphed into an overly complex setting with many layers of EU-supervision over national budgets. Since enforcement of the rules was and is technically and politically not feasible, the concept of Maastricht 1992 failed. Many countries of the Euro-zone would need an economic boost by deficit spending and at the same time cannot spend more credit based, because they are too deep in red already.

Does the Euro-zone really need new economic governance?

Insufficient growth and high unemployment in many member states after the financial crisis broke in

2008 triggered the debate on ´completion of the euro-zone´. But what would make this currency union complete? The ideas are manifold and rarely made clear and explicit enough. A radical answer is ´Maastricht 2.0´. Proponents suggest that the original Maastricht setting – some flexibility added – would work for the Euro-area, if the rules would be respected. In this view the missing elements are the enforcement of already existing deficit and debt rules as well as credible procedure for sovereign bankruptcy. The assumption is that rational financial markets would discipline spendthrift governments. The financial crisis demonstrated, however, that financial markets do not play this role reliably.

Could centralisation of fiscal policy work?

Some Euro-members suggest the instalment of a Euro-zone finance minister endowed with a substantial budget. This budget shall smoothen the business cycle and invest in projects of European public goods with European value added. There are two justifications for doing this on a common instead on a national base:

1. Market failure in case of public goods and
2. Insurance in case of adverse asymmetric shocks, hitting just some countries.

The first rational is convincing, however, those projects cannot be timed along business cycle swings. The second rational is less convincing, since the risk is not evenly distributed; e.g. Greece is more likely to need help than Denmark. In the end a Transfer Union in disguise might be created.

The most serious objection is that most problems are not cyclical but structural. Those can be tackled at the national level only, addressing political sensitive areas like redistribution, competitiveness and innovation. An EU-budget might be (mis-) used for postponing politically painful decisions at the national level.

Even in case of allocating a budget for fiscal policy to the EU-level, the disappointing outcomes of fiscal policy at national levels might just be replicated on a European scale.

EU-wide unemployment insurance and ´moral hazard´

Unemployment insurance and compensation payments still are fully national. How generous and how pro-active this policy should be is one of the hottest topics and has the potential of toppling governments. An EU-wide scheme could insure governments against unforeseen large payment obligations. This, however, could spare them the risk of annoying the electorate by placing a higher burden on recipients or tax payers (´moral hazard´). Again the likelihood of receiving insurance payments seems to be unevenly distributed between member states – resulting in a Transfer Union in disguise.

Banking Union – risk sharing under conditionality?

One of the EU´s brilliant achievements is the Banking Union, which was created quickly as a response to the financial crisis. The elements still missing and still contested are common deposit insurance and fiscal backstop for resolution of banks. Countries with troubled banks prefer a common pool for insuring deposits before removing non-performing loans from the banks´ balance sheets. They hope for more trust in financial markets via insurance. Quite the opposite position is taken by those countries with rather healthy banks and well-endowed insurance funds: ´Risk reduction first – risk sharing second´.

A bank in resolution needs fresh capital during this process. This demand for fresh capital could surmount the funds foreseen for this purpose so that the ESM (European Stability Mechanism) must step in. It could borrow in international capital markets and pass the money on as credit to the respective bank. Liability for the credit stays with the European taxpayer. Therefore some governments want the ESM to step in only after approval by their national parliaments and under the condition, that the receiving country accepts surveillance of her financial conduct. This procedure might be much to slow for providing financial resources in due time.

ECB should become Lender of last Resort

Least controversial is the need of a ´Lender of last Resort´ function provided by the ECB. Beyond written law this is in place already due to Draghi's promise ´… whatever it takes …´. Rules and conditions for this function should be made primary EU law – despite the hurdle of unanimity.

Can common fiscal governance be democratic?

The prominent right of parliaments in democracies is budgetary sovereignty - ´no taxation without representation´ still rules. Therefore any transfer of power over todays or future taxpayer´s money needs approval by all national parliaments. For example, the German Constitutional Court established this ruling. Since the European Parliament is no substitute for national parliament, unconditional transfer of fiscal policy instruments to the EU-level would not be legitimate – unless the foundations are agreed upon by all peoples of the EU´s member states.

The road ahead

Discussions on Euro-area governance are dominated by diverging visions. France and Germany are expected to bring about reforms, but are divided on the strategy. A gulf is growing as well between the ´Hanseatic states´ and the ´Southern Periphery´ on sharing of risks and resources.

Recent political steps in two of the largest member states lowered trust between diverging countries further: The French president gave up his promise of a balanced budget under pressure of public unrest and the Italian government openly and proudly announced the violation of the EU´s budget rules.

The Dec. 2018 council meeting resulted in minor – rather symbolic – steps towards deposit insurance and a small fiscal budget within the framework of the EU-budget. Major steps towards a new concept of fiscal governance could be taken under the roof of a new Treaty only. Agreement on this is not to be expected soon.