Area Studies

Europe

2017

Foreign Policy Research Centre

New Delhi (India)

(www.fprc.in)

2)Dr. Bodo Herzog
Professor of Economics, ESB Business School
Reutlingen University,Germany

3)Dr. Stephen Blank
Senior Fellow, American Foreign Policy Council

4) Dr. Bhaswati Sarkar
Professor of European Studies
School of International Studies,
Jawaharlal Nehru University,New Delhi , India

2)The European Economic and Monetary Unionin the 21st Century

Dr. Bodo Herzog

Professor of Economics, ESB Business School, Reutlingen
Director of IFE – Institute of Finance and Economics
RRI – Reutlingen Research Institute

Dr. Bodo Herzog
Professor of Economics
ESB Business School
Reutlingen University
Alteburgstraße 150,* D-72762 Reutlingen,* Germany
* Email: Bodo.Herzog@Reutlingen-University.de
* Homepage - ESB: Professor Herzog ESB Business School
* Homepage - IFE: Institute of Finance and Economics (IFE Reutlingen)

Abstract

The European Economic and Monetary Union (EMU) has been in turmoil for more than six years. The present governance rules do not seem to solve the problemsneither permanently nor effectively. There is no vision about the future of Europe in the 21st century. This article describes a realignment of theeconomic governance, which do not necessarily lead to a transfer or political union. However, it solvesthe current and future challenges. In fact, theredesign of present rules is the most likely as well as legally and economically option today. The keyideais the detachment from the compulsive idea of an ever-closer union. However, this vision requires boldness towards greater flexibility together with an exit clauseor a state insolvency procedurefor incompliant member states.

Keywords: *EMU, Economic Governance, Future of Euro*
JEL-Classification: *F14, F15, F43, E17, O43*

1. Introduction

Credibility and effective enforcement of the institutional framework is essential for lasting stability of the Economic and Monetary Union (EMU). The legal ban of monetary financing (Article 123 TFEU) and the EU-regulation of the Stability and Growth Pact, the Six- & Two-Pack, the European Semester and the Fiscal Treaty are all of particular importance in order to achieve stability. Nevertheless, the current rules are not sufficient to achieve stability in the end due to legal inconsistencies and moral hazard. In general, there are two policy options to achieve stability in the future: Either the member states transfer decision-making powers to the European level, for example in form of a European fiscal and political union (Enderlein et al., 2016).Or, alternatively, one reforms the presentrule-based approach so that member states have to make their budget decisions by their own and have responsibility for allfiscal consequences (Sinn 2016, Herzog 2016a).

The rule-based approach (or so-called Maastricht philosophy) is the starting point for a reform of the European treaty. I propose to supplement the current institutional framework with either a state insolvency mechanism (SIM) or a credible no-bailoutclause according to article 125 TFEU together with a new exit clause for incompliant states. Both policy options have the prerequisite that the rules and the rule-enforcement in the EMU is fully credible. In fact, an effective insolvency mechanism has several prerequisites (cf. section 2). The major difficulty is to incorporate the new insolvency mechanism into the legal system without creating moral hazard. Indeed, my proposal is closer to a state restructuring mechanism than an insolvency mechanism (Herzog 2016b).The following subsections outline the prerequisites for a stable and lasting future of the EMU.

The first prerequisite of a state insolvency mechanism is the elimination of regulatory privilege of claims against states. Only this can mitigate a direct transfer of risks in the banking system to the state and vice versa. The regulatory de-privileging approach has two objectives:

- Reducing the concentration of risks in bank balance sheets to prevent the insolvency of a single member state from rescuing insolvent banks such as during the financial crisis;
- Increasing the loss absorption capacity of financial institutions, so that losses from state insolvencies could be better coped by banks.

There are currently regulations in the European financial markets, which lead to a privilege of claims on states. Claims on non-governmental borrowers may not exceed 25 percent of eligible capital. This credit limit however does not apply to states! Moreover, there is no obligation to provide capital for claims against states in domestic currencies. Finally, marketable claims against sovereign debtors in the area of liquidity regulation are considered as secure (so-called level 1 assets). In the case of non-governmental borrowers, the regulatory law demands reductions and upper bounds.

Based on stress tests conducted by the European Banking Authority (EBA), the German Council of Economic Experts carried out calculations to illustrate the effects of a reform of the financialregulatory privilege of states (SVR 2015, Chapter 5). The results show a clear heterogeneity across countries as well as a home bias, particularly in southern periphery countries and in Germany. The German Council argues for an introduction of credit limits to all government claims. These limits should vary with the risk because concentration risks in bank balance sheets pose a risk to the financial system as whole, especially in case of default. Independent rating agenciesregularly evaluate the default risk beyond political influence. For the low-rated member countries, the Council proposes a credit limit as for corporate loans of 25 percent in relation to eligible capital. The credit limit is incrementally increasing for countries with better credit ratings. The valuesare similar to the Basel risk-weights. In addition, there is a need for higher capitalratios for banks in Europe. Scientific studies call for an increase to approximately 20 percentin the equity ratio(Admati and Hellwig 2013). Aftera phase-in period of over 10 years, credit limits and the higher equity ratios are binding. The relevant closing date has to be in the past in order to exclude the purchase of privileged bonds, in order to bypass the new regulation.

The second prerequisite is a significant reduction of the public debt-to-GDP ratio. In line with the first prerequisite and according to the Maastricht Treaty,member states debt is limitedto 60 per cent in relation to gross domestic product (GDP). There is a long debate on this issue, however without any lasting action(SVR 2011, paragraph 242 ff., SVR 2013, paragraph 276 ff). In fact, the German Council concludes that the *"high debt of the member states (...) prevents the introduction of an insolvency mechanisms at present time"* (SVR 2015, point 87 ff). Moreover, some solutions for this problem are no longer accessible due to the incompatibility with the current institutional structure. I propose a new solution for this problem without establishing a fiscal capacity or a debt-sharing mechanism (SVR 2016, paragraph 57).If and only if these prerequisites are in place, we can start to reform and redesign the EMU with either an insolvency mechanism or an exit clause.

2. Steps towards a State Insolvency Mechanism in the EMU

A state insolvency mechanism (SIM) should establish a rule-based structure, so that an insolvency can be carried out quasi-automatically along certain milestones. Hence, the SIMis largely deprived of the political negotiation process. On the one hand,this is reducing the uncertainty. On the other hand,it helps market participantsto formcredible expectations. A further building block of an insolvency regulation is a provision that ensures the equal treatment of creditors. This helps to reduce both a 'rush to the exit' and the 'holdout problem'.

2.1 SIM applies only if the default is not the 'fault' of member states

Financial assistance from soundmember states istheoretically completely unnecessary if we have a credible no-bailout clause. However, there are debt crises, which are not directly caused by domestic policy errors. For example, member states may be in a financial crisis because of systemic risks that put the national banking system on the brink of collapse. Or evenmore importantly if there are regionally concentrated industries that are hit by new competitors from emerging economies. Of course, the domestic reaction and adjustmentto exogenous shocks is often delayedbecause it requires unpopular structural reforms (Smaghi 2014). It is not always easy to determine which factor – exogenous shock or wrong economic policy – dominates. However, a state insolvency mechanism in the euro area has to be contingent on extraordinary cases because of the inherent moral hazard thatis even amplifiedin the monetary union (Beetsma and Bovernberg 1999, 2000, 2003, Beetsma and Uhlig 1999, Dixit and Lambertini 2003, Herzog 2004, 2016b). As a result, the principle of self-responsibility and no-bailout (especially inhomemade crises) have to be the gold standard. In so doing, the onset of the SIM for an indebted country is contingent on the compliance of all its legal obligations –existing rules. If the country is not able to solve the crisisby their own, despite of structural reforms and austerity measures, conditional rescue funds are available such as the European Stability Mechanism (ESM).

2.2 The Use of SIMs Must Be Unattractive

In order to mitigate moral hazard, the SIM must be unattractive. In fact, the SIMcould be seen as a lender-of-last-help. There are different options to implement this disincentive. Ultimately, it is about the loss ofbudgetary autonomy for countries under the SIM. An extremeform of such an intervention would be a state insolvency administrator, e.g. a European Finance Minister. The impending loss of the budgetary autonomy could foster financial discipline ex ante. This has similar effects as an exit clause as an alternative proposal to a state insolvency mechanism.

The disincentive effect is manifold. First, there would be a considerable loss of prestige for the national politicians. Secondly, there would be the danger of losing regional and cultural identity. In the case of economically weak and politicallyunsound member states, this could promote the preference of a voluntary exit from the monetary union. For this reason, the possibility of a self-determined voluntary exit has to be legislated in a SIM as well. In case of lasting policy failures ora sustained incompliance with European rules,member countries must exit the EMUin order to achieve the necessary credibility of common rules (ie, a credible threat!). Sinn (2016) labels this idea a 'breathing currency union'.

A less radical option would be to suspend only the financial autonomy or at least the autonomy of the expenditure side during the period of crises. However, this would require EU competencies to enforce the national budgetlaw (Calliess 2017). For this purpose, the competencies of the EU-Commission has to be strengthened under an SIM. For example, if spending cuts are possible but the governmenthas not yet implemented the cutsbecause they are unpopular, then the EU-Commissionhas the legal rights to enforcethe necessary steps. However, such a regulation could make it attractive for governments to delay unpopular structural reforms until the EU-Commission is doing the ugly jobs.

3. Conclusion

No doubt, a state insolvency mechanism (SIM) in the EMU is no silver bullet. Of course, it would reduce the risk premiumfor the heavily indebted member states butat the same time offer an incentive to be less sustainable. Indeed, there is the risk that the highly indebted states today hope to get rid of their debts tomorrow by the new insolvency mechanism. In order to eliminate theseconsiderable moral hazard incentives, the implementation of a state insolvency mechanism (SIM) can only work under the strong requirements. Admittedly, a SIM constraints national sovereignty but only for indebted countries that are incompliant to the commonly agreed rules.

If one wants to stabilize the EMU without the potential disputes in the course of a European insolvency mechanism, there is only one other alternative: the inclusion of an automatic exit clause for incompliant member states. Only this has the same disciplinary action on heavily indebted and incompliant member countries in the EMU. From a sober point of view, currently there is no 'no-bailout' in the euro area, since the policy practicehas been a bailout of indebted countries such as Greece. In short: without a credible NO-BAILOUT clause, i.e.either an effective insolvency regime or an exit clause, the stability and soundness of the European monetary union remains in question.

References

Admati, A. und M. Hellwig (2013), Des Bankers Neue Kleider, FBV Verlag, München.

Beetsma, R.M. and A.L. Bovernberg (1999). Does Monetary Unification Lead to Excessive Debt Accumulation?. *Journal of Public Economics*, 74(3): 299–325.

Beetsma, R.M. and A.L. Bovernberg (2000). Designing Fiscal and Monetary Institutions for a Monetary Union. *Public Choice*, 102(3–4): 247–69.

Beetsma, R.M. and A.L. Bovernberg (2003). Strategic Debt Accumulation in a Heterogeneous Monetary Union. *European Journal of Political Economy*, 19(1): 1–15.

Beetsma, R.M. and H. Uhlig (1999). An Analysis of the Stability and Growth Pact. *Economic Journal*, 109(458): 546–71.

Calliess, C. (2017), Durchgriffsrechte in die nationale Haushaltsautonomie, Reflexionsgruppe, Diskussionpapier, Konrand-Adenauer-Stiftung.

Dixit, A. and L. Lambertini (2003). Symbiosis of Monetary and Fiscal Policies in a Monetary Union. *Journal of International Economics*, 60(2): 235–47.

Enderlein, H. et al. (2016), Repair and Prepare: Der Euro und Wachstum nach dem Brexit, Bertelsmann Stiftung, Gütersloh.

Herzog, B. (2016a), *Neujustierung der Governance der Europäischen Währungsunion*, p. 1-46, Konrad-Adenauer-Stiftung, Berlin, ISBN 978-3-95721-206-1.

Herzog, B. (2016b), Modelling Monetary and Fiscal Governance in the Wake of the Sovereign Debt Crisis in Europe, Economies, 4(2), 9. doi:10.3390/economies4020009

Herzog, B. (2010), Anwendung des Nachhaltigkeitsansatzes von Bohn zur Etablierung eines Frühindikators in den öffentlichen Finanzen – Beitrag zur aktuellen Debatte der Föderalismuskommission II, *Journal of Credit and Capital*, 43. Jahrgang, Heft 2, S. 1-24.

Herzog, B. (2004). Warum verstoßen vorwiegend die großen EWU-Länder gegen den "Stabilitäts- und Wachstumspakt"?. *Quarterly Journal of Economic Research*, 73(3): 405-417.

Perotti, R. (2014), Fiscal Policies in Recessions, ?, in: What have we learned? Macroeconomic Policy after the Crisis, eds. G. Akerlof, O. Blanchard, D. Romer and J. Stigilizt, MIT Press.

Sinn, H.-W. (2016), Der schwarze Juni, Herder, Freiburg.

Smaghi, L.B. (2014), Monetary Policy, the Only Game in Town?, in: What have we learned? Macroeconomic Policy after the Crisis, eds. G. Akerlof, O. Blanchard, D. Romer and J. Stigilizt, MIT Press.

SVR (2016), Jahresgutachten 2016, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Wiesbaden.

SVR (2015), Jahresgutachten 2015, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Wiesbaden.

SVR (2013), Jahresgutachten 2013, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Wiesbaden.

SVR (2011), Jahresgutachten 2011, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Wiesbaden.

(Version: April 2017)

*****