Diverging or Uniting Europe?

We asked each of the speakers of the Workshop 3 questions about their statements. The answers can be found below. The Workshop was to discuss the situation and future of the EU and especially the Euro Area in the middle of a deep crisis. It is highly controversial among politicians as well as academics which way or ways out should be sought. Against this backdrop IMK organized its “Future of Europe” workshop bringing together academic scholars of economics and political science to discuss the relevant issues.

The debate addressed several fundamental questions on a future Europe. A critical assessment was made of the economic policies implemented so far, because measures taken have deepened the rift among member countries rather than bridging it. This immediately leads to the question whether the Euro can be saved as a common currency. The structural heterogeneity of the Euro area with respect to wage and price formation as well as economic policy approaches speaks against it. It is difficult in the absence of convergence-promoting policies to preserve monetary stability under these circumstances. On the other hand, the growth potential of a joint currency and the undisputed high costs of a break up were seen as arguments in favour of keeping the Euro.

All this happens in a situation where uncertainty is significantly enhanced. Financial investors are desperately seeking safe assets they cannot find anymore. The reason is that government bonds can no longer play this role under new default rules. While some scholars find this appropriate to avoid moral hazard problems that might encourage national governments to get over indebted, others see it as a source of increased uncertainty that hampers investment and growth.

This issue is a special case of more general question of utmost importance: Should European politics be re-nationalised or must it become more integrated to preserve a stable Europe, given that the status quo is not sustainable. The former provides a chance to reconcile diverging national interests with at least a reduced form of a European community. The latter would establish a new kind of European stability which results from a truly European perspective beyond national interests.

A crisis in its original meaning is a situation where decisions have to be taken that will lead one way or the other. Presently it is still far from obvious which way should be taken. This suggests that the crisis will continue.
ASSESSMENT OF EURO AREA POLICY

Björn Hacker, Professor of Economics at Hochschule für Technik und Wirtschaft (HTW) Berlin

1. **How do you assess in general economic policy in the Euro Area since the crisis?**

The short political consensus in the wake of the global financial crisis on tackling economic downturns with countercyclical fiscal policies disappeared too quickly. Since 2010 the crisis management of the Eurozone is dominantly based on ordoliberal, supply-sided thinking. Mainly influenced by the German government, austerity became the central instrument to organise an internal devaluation in Greece, Portugal, Ireland and other countries in liquidity troubles. Cutting wages and public spending in the middle of a recession led to a further drop in demand and aggravated economic downturn. The ECB alone is not capable to change tack and while fiscal incentives remain modest, a long stage of economic stagnation is conceivable.

2. **What could have done better?**

A look at the other side of the Atlantic shows the potential of a consequent countercyclical monetary and fiscal policy: The U.S. does far better in its economic growth and unemployment rate compared to the Eurozone, which has not got back to its pre-crisis levels yet. It is useful that the European Commission now uses a broader interpretation of the Stability and Growth Pacts’ flexibility, thereby opening new doors for Member States fiscal stance. Nevertheless, much more is needed to end the deflationary bias of the Eurozone. Necessary would be an immediate pan-European investment program and a better symmetry of measures to end the crisis between the Euro19 States. Up to now, mainly the countries with current account deficits correct macroeconomic imbalances, while responsibilities of the current account surplus countries only play a marginal role.

3. **Will the Euro survive?**

This depends in the short term on a turnaround in austerity policies towards more investments. As long as the crisis is artificially extended on the costs of low economic growth, high unemployment and increased poverty, nobody shall wonder why populist parties raise their voices all over Europe. If the crisis management constantly fails to deliver sustainable solutions for the monetary union and accepts an ever growing divergence between its members, calls for breaking-up will intensify. In the long-term perspective, the huddles of this severe crisis have to lead to a new Eurozone architecture. But alike the ad hoc crisis management, a freshly designed monetary union will has no chance, if it is based purely on enforced budget supervision. Maintaining the status quo of a ‘Stability Union’ cannot be a sustainable solution and won’t prevent us from the next crisis. The only way forward would be a completion of the Eurozone as a ‘Fiscal Union’ with much more political cooperation and coordination needed.
SHOULD THE EURO BE SAVED?
Andreas Nölke, Professor at the University of Frankfurt

1. **You strongly argue in favour of giving up the Euro. Why?**

   Although the Euro is very helpful for the performance of German export sector companies, it has led to a lot of economic misery in other parts of the Eurozone. A progressive reform of the Eurozone is conceivable, but the necessary reforms – such as a decade of over-proportional wage increases in Germany, transnational wage coordination and strongly increased fiscal redistribution via the EU – are politically extremely unlikely. Neither are German firms and work councils willing to give away their competitiveness, nor do we have European structures for wage negotiations, particularly on the employers’ side. And there currently is neither sufficient pan-European solidarity for massively increased permanent fiscal transfers, nor for the jump in European integration that necessarily would need to go along.

2. **Don’t you fear major currency crises in the aftermath of a Euro abolishment?**

   Indeed a disorderly break-up of the Eurozone would certainly lead to major currency crises. In order to prevent both long-term economic stagnation (with the Euro) and major currency crises (with a disorderly break-up), we need to develop progressive alternatives to the Eurosystem, such as a reformed European Monetary System (EMS). The old EMS worked much better than the current Eurosystem and a reformed system would even overcome some of the old EMS’ weaknesses, such as the overly strong position of the Bundesbank. The latter could be replaced by a European Monetary Fund, based on the existing institutions of the European Central Bank and the European Stability Mechanism. The Euro could be kept as an external currency, like the old ECU. In order to soften the turbulent transition phase, the introduction of a reformed EMS would need to be accompanied by capital controls and a one-off European Marshall Plan.

3. **Is a Europe without a Euro a better Europe?**

   Given the institutional heterogeneity of the Eurozone member economies, Europe needs a somewhat more flexible currency arrangement. If we do not go ahead with a radical reform of the Eurosystem, we are risking continuing economic misery and increasing political unrest in large parts of Europe. Moving in the direction of even more powerful European integration – such as increased EU-level fiscal redistribution – is no option at the moment, since this would further strengthen right-wing populist parties in many Northern economies. The latter parties would be able to exploit the uneasiness of many citizens with a European super-state. Correspondingly, a Europe without the current Eurosystem would indeed be a better Europe.
SHOULD THE EURO BE SAVED?

Gustav A. Horn, apl. Professor University of Duisburg-Essen, Director IMK (Macroeconomic Policy Institute)

1. **You strongly argue in favour of keeping the Euro. Why?**

   Dissolving the Euro area in the present situation would impose severe economic harm on all member states. The most important impact would occur by the uncertainty triggered already by the decision to do so. Financial markets would dive and investment would stall. A deep recession with high unemployment would be inevitable. This all, just to end up in currency regime with a probably pegged or managed exchange rates that recreates the uncertainties we have already seen in the early nineties. At the end of the day a new but less dynamic Europe would emerge. Low growth, higher interest rates and lower employment compared to a situation where we would have a properly managed currency union is the result.

2. **But do you think the Euro is properly managed? Don’t you fear that present instabilities may destroy the Euro area?**

   Indeed the Euro area is not properly managed. And there is a real danger of breaking-up. But in this case you have two possibilities. Either you try to improve economic policy of the Euro area in order to achieve a properly currency area. That is what I recommend. Or you give up hope. Then it is better to dissolve the joint currency. But you should not assume that policy makers who failed to run a currency union properly could nevertheless succeed in managing an exchange regime in an optimal way. They have failed in the nineties, they have failed during the currency union and they will fail thereafter again. What you need is a better economic policy and I prefer to achieve that inside a currency union and not outside.

3. **Would a Europe without a Euro not be more stable?**

   A joint currency creating an economically huge domestic market is a protection against all sorts of external shocks, notably exchange rate turbulences. In addition to that, trade between member states becomes cheaper and domestic trade gets a higher share of trade. Moreover the effectiveness of economic policy is enhanced taking place with only one currency. So already in principle a currency union is more stable. Given the policy failures to be expected in a pegged currency regime it seems obvious to me that a more instable situation is waiting for Europe if the Euro is gone.
1. **You strongly advocate a renationalisation of eurozone policy. What went wrong?**

I advocate scrapping the fiscal compact and the tighter fiscal rules - or at the very least greatly loosening them - because they are economically harmful and deny voters legitimate democratic choices about tax and spending decisions. No taxation - or no welfare cuts - without representation is the stuff of revolutions.

This fiscal straitjacket was the price that Chancellor Merkel and the previous coalition government demanded for providing 'bailouts' to Greece and other eurozone governments. Germans feared that they could end up liable for everyone else's debts and German policymakers seized the opportunity to try to impose an ordoliberal model on the rest of the eurozone.

But this devil's bargain was based on a false premise. German taxpayers' money wasn't needed to 'save' the eurozone; the debts of insolvent sovereigns and banks needed restructuring instead. And that money didn't bail out taxpayers in southern Europe; it primarily bailed out southern Europe's private creditors, often German banks.

2. **You are also against Eurozone safe assets. Why?**

I'm not in principle against the creation of a common eurozone Treasury that would issue 'safe' bonds. I just don't think it is politically feasible any time soon, partly because of a lack of democratic support for such a step change in integration and partly because the current German government wouldn't agree to it, or would do so only with conditions that made it politically intolerable to people in other eurozone countries.

I do think the eurozone needs a mechanism for restructuring sovereign debt, based not on destabilising automatic rules but rather on independent judgement. Had an insolvent Greece's debts been restructured in 2010 - or if its private creditors had been locked in for a few years until it was clear that the adjustment programme couldn't restore Greece's solvency - the poisonous transformation of the eurozone's political economy could have been avoided. Greece wouldn't be run as a colony of its eurozone creditors. German taxpayers wouldn't resent Greeks because of the German government's deception that their money was bailing out profligate Greeks when it was actually bailing out German and other banks. Losses would rightly have fallen on the reckless banks who mistakenly lent so much to Greece, not European taxpayers.
3. In the absence of safe assets, do you not see the danger of enhanced uncertainty?

Is the Eurozone’s current institutional framework unstable? Yes. It hinges on markets believing Mario Draghi’s promise to do whatever it takes (within the ECB’s mandate) to hold the Eurozone together. Would it be better to formalise the OMT by officially making the ECB the unconditional lender of last resort to illiquid governments? Yes. At the same time, the Eurozone needs a mechanism for dealing with sovereign insolvency (which is distinct from a solvent government being pushed towards default by a liquidity/refinancing crisis, ie, a panic). It isn’t always immediately clear-cut whether a government is insolvent or illiquid, which is why such a mechanism requires discretion and the option of delayed judgement. Would that increase uncertainty? No, it would provide greater predictability. Had it existed and been used in 2010, the ensuing catastrophic policy blunders that caused the 2011-2 panic that almost destroyed the Eurozone could have been avoided.
DO WE NEED SAFE ASSETS?

Peter Bofinger, Professor at the University of Würzburg, Member of the German Council of Economic Advisers

1. **You strongly argue in favour of Euro area safe assets. Why?**

   The Great Recession has demonstrated that large economic shocks can only be compensated successfully if there are governments which are able to run very high deficits. In the Euro area this was not possible due to the specific insolvency risk with which the member states are confronted. As a consequence in 2010/2011 several member states were cut off from the markets and were forced to adopt severe consolidation programmes although the economic situation was not ripe for this. This forced the whole Euro area into a second recession in the years 2012/13. With a formalized government insolvency regime, which is currently proposed by many economists, the ability of the member states to respond to severe shocks in the future would be even more limited.

2. **Do you not see any danger of moral hazard?**

   A common currency area has only two alternatives for limiting moral hazard of national fiscal policies. It can try to use market discipline. This was the philosophy of the Maastricht Treaty with its strong no bail-out clause. The experience since 1999 has shown that market discipline is not an effective tool. The Delors Report predicted already in 1989: “The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.” Therefore, the risk of moral hazard requires an effective political discipline. In contrast to the status quo political discipline should be exerted from a supranational institution and not by a council of ministers. In addition, the institution that is in charge of fiscal surveillance needs a democratic legitimacy by the European Parliament.

3. **Are you in general in favour of an enhanced European policy approach?**

   The ECB has so far been able to deal successfully with the deficiencies of the architecture of the Euro area. But this cannot be regarded as a permanent solution. Therefore, for the long-term survival of the Euro area an enhanced European policy approach which combines more political integration with some form of debt mutualisation is indispensable.
SHOULD EUROPEAN POLICY BECOME NATIONAL AGAIN?

László Andor, former EU- Commissioner, IMK Senior Research Fellow

1. What do we need in the Euro area? A step back with a more renationalized policy approach? Or do we need further Europeanisation of policy?

The idea to renationalize risk as well as governance within the EMU, as represented by Philippe Legrain, Simon Wren-Lewis, Martin Sandbu and others, is tempting but in my view wrong. Renationalisation could be the optimal solution in case the door is entirely closed towards fiscal union. But even a partial fiscal union is superior to renationalisation (while keeping the single currency). Renationalisation would require a sophisticated risk management and resolution mechanism, in order to avoid that small and medium size member states appear again as “too big to fail” and trigger ad hoc sovereign lending solutions with counter-productive conditionality (such as in 2010). Renationalisation does not offer solutions to divergence which is the main threat to the sustainability and legitimacy of the EMU. If, however, the banking union cannot be completed and fiscal union cannot be launched, renationalization probably remains the only option, but at the end with the renationalization of currency as well.

2. In what fields do you see the necessity to change the European policy approach?

First of all, I do not think EMU reform can continue as a slow motion, incremental process. The Eurozone has not recovered properly from the long recession and we are headed towards the next downturn without having sufficiently reinforced our structures. At the same time, the Eurozone periphery, and especially Southern Europe still struggles with the social and political consequences of the crisis. Governability is in question in several countries. Hence the need for a more comprehensive approach to reforming and reinforcing the single currency, if we want to save it at all. The key question is how to create a (counter-cyclical) fiscal capacity through a combination of possible elements, like further relaxation of fiscal rules, establishment of automatic stabilisers, and the appointment of a eurozone finance minister.

3. What would be the benefits of such an approach?

Any major step towards a Eurozone fiscal safety net would trigger positive reactions from the financial markets, which always looked at the periphery countries with suspicion in the absence of clear commitment from the community as a whole to maintain solvency and integrity. Completing the banking union with deposit insurance would make it truly effective, and automatic fiscal stabilisers can reduce the negative economic and social impacts of any future downturn. Of course, the design of such schemes would matter a lot, but the tremendous expert work of the recent years has delivered sufficient preparations for rapid decision making, when the political momentum emerges for that.