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Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

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Completing the Unfinished House:
Towards a Genuine Economic
and Monetary Union?*

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I. EMU, a Unique Experiment

The European Monetary Union (EMU) represents an unprecedented institutional arrangement. Never before in history have states, while maintaining their individual sovereignties, voluntarily renounced their national currencies in favour of a new common currency and ceded their authority over monetary policy to a supranational central bank. It can therefore be said that on January 1, 1999, when this new currency—the euro—was adopted, a bold experiment began, the outcome of which is still under debate 16 years later.

This experiment has three dimensions—political, economic and monetary integration—which form the legs of a new and difficult "triangle" (Issing 2004). While the establishment of the European Central Bank (ECB) solved the monetary challenge on the institutional level, the problem of conducting a "one-size-fits-all" monetary policy continues to be a tremendous task due to economic divergences across the eurozone countries.

At its inception, EMU united a heterogeneous group of eleven countries. Enlargement has increased this diversity further, such that today's EMU would be even less able to meet the strict criteria of the theory of an optimal currency area. Whether these are the exclusive criteria for forming a monetary union is debatable given that the crisis itself triggered structural convergence—an endogenous process through which the countries have come somewhat closer to the optimal currency-area criteria ex post. Nevertheless, while there has been undeniable progress in the programme countries, substantial divergences still remain.

Thus, EMU is first and foremost a political project. The highly unpopular abandonment of the Deutsche Mark was a clear signal of the German government's commitment to irreversible European integration—which required action on political, economic and monetary fronts.[1] As former German Chancellor Helmut Kohl announced to the German Federal Parliament in a speech on November 6, 1991, "It cannot be repeated often enough. Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy."

[1] This was in contrast to the views of several leading French politicians in 1990, such as Jacques Chirac and finance minister Édouard Balladur, who were adamantly against a single European currency (Tietmeyer 2005) and even more against an independent European central bank.

A large majority of German economists shared this position. Political union should come first or at least contemporaneously with monetary union; beginning with the monetary union was putting the cart before the horse. Indeed, by the time of the introduction of EMU on January 1, 1999, no further progress toward political union had been achieved; in fact, it had not even been attempted.[2]

II. The Euro: Catalyst to Political Union?

In light of this lack of political progress, there are three conceivable scenarios. In the first, the monetary union will in the course of time develop into a fully-fledged political union. In the second, the monetary union will survive without political union. In the last, the monetary union will—like its predecessors in history—collapse because of the lack of a political union.

In beginning with this last option, there is no need to embark on details of former monetary unions like the Latin Monetary Union. Such a comparison misses a fundamental point. The euro-area countries (and even the EU countries) already share a number of elements of political union. In the euro area, there exists a supranational central bank—the ECB—and a common currency. A central bank does not make a state, but it is an important component of statehood. Furthermore, eurozone countries have already transferred additional elements of national sovereignty to the supranational level. These include exchange rate policy, competition policy, trade policy and, most recently, banking supervision.

The euro area is today built on a complex system of mixed and joint competences and common rules. These include the European Council as an intergovernmental group, the European Parliament and the European Commission. In many fields majority voting has overcome the need for unanimity. The increasing role of the European Court of Justice must also not be forgotten. These institutions amount to substantial "political-union character" in the euro area, and so the original question must be reformulated: Can EMU function and survive with the current degree of political union?

[2] It is interesting to note that in 1990 the German side insisted that negotiations on monetary and political institutional integration should proceed in parallel (Tietmeyer 2005). It turned out that this found no support on the French side and amounted to nothing.

The introduction of the euro has been instrumental in enlarging and deepening "Europeanization" of competences. However, the rather old idea that a common currency would function as a catalyst for political union went beyond that. It was argued that a stable common currency would foster a universal European identity. This hope has since been bitterly disappointed and the original argument turned upside down. The eurozone crisis and the failure of several national governments to live up to their commitments and reform their economies within the monetary union are now viewed as evidence that Europe must transfer even more competences and spending powers to the European level, and in this way move in the direction of political union, especially in the field of fiscal policies—for example, by adopting cross-country transfers and risk sharing.

III. The Report of the "Five Presidents"

Politicians, economists, philosophers and countless other writers have presented ideas on how to react to the euro crisis and bring EMU closer to political union. This article will focus on the most recent and prominent proposal.

On June 22, 2015, the "five presidents"—representing the European Council, the European Commission, the Eurogroup, the European Central Bank and the European Parliament—presented their report, "Completing Europe's Economic and Monetary Union" (Juncker et al. 2015)[3].[4] The proposal comprises two stages, both to be achieved by 2025, at which time "a deep and genuine EMU would provide a stable and prosperous place for all citizens of the EU Member States that share the single currency, attractive for other EU Member States to join if they are ready to do so" (p. 5).

The report's first chapter is titled, "The Nature of a Deep, Genuine and Fair Economic and Monetary Union". One must not engage too deeply in questions of terminology, yet it is reasonable to ask what constitutes a "genuine" union, and how it differs from one that is just "deep". Furthermore, what is the notion of a "fair" union? Obviously the authors interpret the present arrangement as unfair. But does "fairness" refer to the consequences of one country's taking unfair

[3] Elsewhere, page numbers in parentheses are references to this report.
[4] The report is a follow-up to the so-called "Four Presidents' Report," which had been presented by the same group (excluding the president of the European Parliament) on December 5, 2012. The 2012 report, "Towards a Genuine Economic and Monetary Union", was written at the "invitation" of the European Council.

advantage of membership in EMU? Or does "fairness" extend to the equality of individuals in member states?

It is not surprising that the authors remain vague on their definition of fairness. Revealing the consequences of transfers between member countries or similarly minded regulations would jeopardise their chance of acceptance. In this context the report neglects that poorer countries already get substantial transfers via the EU budget—up to 5% of GDP per year. Moreover, countries hit by the debt crisis receive considerable financial support through subsidised credit and prospects for debt relief.[5] While the presidents are bold in arguing in favour of higher transfers, they fail to criticize heavy tax evasion, clientelism and corruption—all severe causes for the failure of national policies.

IV. Completing the Unfinished House: European versus National Responsibilities

"Europe's Economic and Monetary Union today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilized quickly. It is now high time to reinforce its foundations and turn it into what EMU was meant to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress" (p. 4).

Who would not support this manifesto? These are goals easily accepted by all countries and welcomed by their citizens. To the extent that this is a plea to finalize the single market and to remove remaining barriers to the free flow of people, goods, services and capital, this is indeed consistent with a programme to foster growth and employment. However, the argument that follows—that achieving these goals requires "further steps to complete EMU"—is anything but straightforward.

In this context the report demands progress towards a genuine *economic* union that "ensures each economy has the structural features to prosper within the Monetary Union" (p. 4). What follows, in chapter 2, is a long list of objectives, measures and reforms pointing in the right direction. However, all of these arguments are long well known. Numerous analyses exist demonstrating, for example, why structural or youth unemployment is extremely high in some countries—in most cases since

[5] Sinn (2014) calculated that Greece, for example, has received public credit which in relative terms was forty times the credit given to Germany under the Marshall Plan.

long before EMU was created. It is hard to see how national responsibilities, the poor quality of some national institutions and a lack of reform can be overcome by European surveillance and administration. Establishing new "Competitiveness Authorities" will in all likelihood increase red tape but not solve the fundamental challenge of providing proper incentives for implementing well-understood structural reforms. What's more, adding the continent-wide goal of earning a "social triple A" in employment and welfare policies (p. 8) is nothing more than empty political speech and an example of wishful thinking. To make all of Europe responsible for eventually missing ambitious goals will not foster European integration but instead cause the opposite.

The Lisbon Agenda of 2000, which sought to make Europe the most dynamic region in the world, provides a cautionary example of failing to meet ambitious goals. Dutch Prime Minister Wim Kok's 2004 proposal to hold national governments accountable to these reforms by "naming and shaming" them in annual reports was bluntly rejected, not least by the German government, and the Lisbon Agenda is now widely considered a failure. One might think that the chances for implementation should now be better. However, recent experience points in the opposite direction. The European Commission has watered down the application of the Stability and Growth Pact and the Macroeconomic Imbalances Procedure to accommodate national sensitivities and wishes. This undermines the objective of "having suitably resilient economies and sufficient fiscal buffers" that the report demands (p. 4).

This chapter contains many well-known suggestions which, if implemented, would lay the foundation for substantially better growth, employment and productivity in the euro area. Since the starting point differs significantly across euro-area countries, those with the greatest rigidities in labour and product markets would have the best chances of reaping benefits. But the report is weak when it comes to showing how the proposals for a "genuine union" will support the achievements of such objectives and not further reduce the incentives for national governments to implement necessary reforms.

Ultimately, if the costs of poor national policies are increasingly borne by other European states, there is little reason for one to expect that certain governments will finally fight tax evasion, stem corruption and overcome the vested interests that are blocking reforms. It is more than disappointing that there has been no significant process of real convergence among the 12 countries that adopted the euro in 1999 and 2001 (ECB 2015). But it is also not surprising. Capital flows to low-income countries were misallocated, and EU funds misused to strengthen privileged groups and corrupt institutions. It remains in the first place a national responsibility to implement badly needed structural reforms.

V. Creating Financial Union

Only a single financial market that is consistent with economic union and the single monetary policy will allow shock-absorbing risk diversification across member countries. Thus, in chapter 3, "Towards Financial Union—Integrated Finance for an Integrated Economy", the report covers measures to complete the banking union and launch the capital market union.

The Single Supervisory Mechanism (SSM) has been established, and given the pro-integration stance of the European Court of Justice, it is no longer necessary to consider whether Article 127(6) of the Treaty on the Functioning of the European Union (TFEU) allows the full transfer of banking supervisory power to the ECB. Regardless, there remain strong arguments against giving the ECB a role in micro-prudential supervision. In its 2009 report, the High-Level Group on Financial Supervision in the EU (2009) noted three such arguments: potential conflicts with monetary policy, greater risk of political pressure and possible interference with the ECB's independence in cases where taxpayers have to provide financial support for banks. The High-Level Group therefore suggested that the EU take steps leading to the creation of an independent European Supervisory Authority. The Commission and the Council initially approved this report.

It is surprising that the five presidents neglect to mention the idea of an independent authority for bank supervision in their otherwise forward-looking report. While the 2009 approach would have required a change in the TFEU, the chances of which seem dubious at present, the recent report includes other proposals that would require treaty changes. Do the presidents assume that leaving responsibility for the SSM with the ECB is the optimal solution?

Proposals for the other pillars of the banking union—single bank resolution and single bank deposit insurance—have already raised intense controversy. How should bridge loans and a common backstop for the single resolution fund be financed? Private funding will never be sufficient, and it is therefore a tremendous challenge to find a solution which avoids moral hazard and guarantees democratically legitimate investment of public money. The report suggests that a common backstop could be attained "through a credit line from the European Stability Mechanism (ESM) to the Single Resolution Fund", with the backstop being "fiscally neutral over the medium term by ensuring that public assistance is recouped by means of ex post levies on the financial industry" (p. 11). But should one rely on such a vague concept?

The report also does not address the roadblocks that remain in establishing a common deposit insurance scheme beyond the countries' current programs. Crucially, there is no discussion of the legacy problem: "Europeanizing" existing national funds, which has been proposed time and again, is nothing more than an euphemism for expropriation, and not a strong argument in favour of European integration. Furthermore, European-wide deposit insurance will subsidise structurally weak, largely non-diversified banks which have strong and toxic links to highly indebted sovereigns. Such a subsidy will undermine the incentive for shareholders and national authorities to improve the resilience of their vulnerable banks via diversification, additional capital and cross-border integration. There will be irresistible political pressure to avoid requiring these weak banks to pay an adequate risk premium for the deposit insurance. Under these circumstances, deposit insurance will undermine the objective of private risk sharing via financial markets. Should this risk not have been addressed in the report?

The capital market union would complete the financial union by strengthening cross-border risk-sharing through more deeply integrated bond and equity markets, providing a buffer against country-specific shocks in the financial sector and strengthening private sector risk-sharing across countries. While these are indeed important goals, they can only be achieved by a well-designed framework, which has yet to be developed and which the report does not provide. The report does, however, rightly recommend that the union include all 28 EU member states in order to avoid a further rift between euro and non-euro members.

VI. The Challenges of Limited Fiscal and Political Union

The least complete part of EMU's "unfinished house" is political union. The report insists on parallel developments in the field of fiscal and political integration. It does not plead for a fully fledged fiscal and political union, "only" for steps in this direction. We will see that this aspect is crucial in assessing the report of the five presidents.

The report advocates for the creation of a European Fiscal Board, whose independent experts would provide a public yet independent assessment of how national budgets and their execution perform against the economic objectives and recommendations set out in the EU fiscal governance framework. The success of this idea—which has been aired elsewhere—depends on the full independence of the board from national governments and the European Commission, on far-reaching transparency requirements and on the individuals selected. Yet it deserves a try.

More controversial is the scheme to set up a macroeconomic stabilisation function for the euro area. Given that the authors emphasize that the Stability and Growth Pact remains the "anchor for fiscal stability" (p. 18), observance of its existing rules should be a prerequisite to arguing in favour of an additional, "euro area–wide fiscal stabilisation function" (pp. 14–15). Remember, the Pact holds that in normal times a country should maintain a balanced budget—or a surplus in the case of high public debt. When confronted with a cyclical downturn, the country (if it has observed the Pact) has the latitude of 3% of GDP for fiscal stabilization measures, and in the event of a severe recession, the Pact allows even more room for budget deficits. Over time, however, the Pact has lost more and more respect, and the present European Commission has downgraded it to a measure applied on the basis of pure political discretion. Under these circumstances, how can the five presidents' statement that "we need to reinforce trust in the common EU fiscal governance framework" (p. 14) be taken seriously?

Similar to previous proposals for a "European finance minister", the report suggests establishing a euro-area treasury to enable the "joint decision-making on fiscal policy" required in a fiscal union (p. 18). The authors make clear that this partial transfer of national fiscal sovereignty needs arrangements for democratic accountability, legitimacy and institutional strengthening, and to achieve this goal, they present a number of institutional arrangements, especially involving closer cooperation among the European Parliament, national parliaments and the Commission.

These are all moves in the direction of political union. However, the combination of *limited* transfer of fiscal sovereignty and *limited* democratic legitimacy is a dangerous path to follow. Limited democratic legitimacy will prevail as long as the transfer of fiscal sovereignty is not based on changes in national constitutions.

The five presidents' proposal to integrate the European Stability Mechanism (ESM) into the EU treaties indicates their preference for centralized authority over national sovereignty. While the ESM's inter-governmental structure, governance and decision-making process are indeed cumbersome, taxpayers' money is at stake, and so national parliaments must currently agree upon its use. This is not only the opinion of the constitutional court in Germany. Under the existing

European arrangement, the political responsibility for international transfer payments and their financing remains with the national governments, controlled by their parliaments and electorates.

Political union in Europe cannot be attained through the back door by steadily eroding national sovereignty over fiscal policy. On the one hand, this would create moral hazard; on the other it would fuel resistance to enforced transfers. Following this path would undoubtedly lead to tensions that might even jeopardize the degree of integration that has been achieved to date. Violating the principle of "no taxation without representation" is a dangerous approach to deepening European integration (Issing 2008).

The European monetary union will continue to exist without political union for a considerable period of time; the euro will long remain a currency without a state. Put another way, EMU will remain an institutional arrangement between states, which will insist in principle on their sovereignty over fiscal issues. If member countries respect the wish of their people to retain fiscal sovereignty, the institutional arrangement for monetary union has to guarantee that national governments will be held accountable for their economic policies. The no-bailout clause will be indispensable. Treaties and commitments must again be respected: *Pacta sunt servanda*. If this principle is permanently violated, how can one expect a prosperous future for Europe from a new set of treaties even more demanding than the old and present ones? That the proposed new treaty elements would create incentives, rather than sanctions, for violations of the rules provides additional grounds for scepticism about their success.

VI. Conclusion

The report of the five presidents presents a programme for EMU to escape from its present inefficiencies and to develop in the direction of political union. This seemingly pragmatic approach has advantages but also embodies dangerous ambiguities and pitfalls.[6]

The future of Europe and EMU must be viewed in the context of global developments and regional objectives. It is true that Europe can only play an appropriate role in the world if it acts in unity. Unfortunately, in crucial fields like foreign policy or defence (not to mention the political rift on the refugees challenge), Europe is far away from having a common policy. The latest five presidents'

[6] The German Sachverständigenrat (2013) has presented an alternative approach.

report does not touch upon these fields; this is a result of their wise decision to concentrate on the economy and related issues. This contrasts with philosophers like Jürgen Habermas (2009), who are convinced that via "more" Europe the "ideology of neoliberalism" can be overcome, and with the left movement now extending from Greece and Spain to the United Kingdom, which pretends to have a vision in the same direction. It is hard to imagine that these ideas can contribute to strengthening Europe's position in the world. What has been announced so far is a backward-looking approach with ideas that have failed miserably in the past.

On the contrary, the five presidents focus on improving the European economy because they view improvement in the prospects for growth and employment as a necessary condition for a better future in Europe. The history of European integration after World War II suggests that economic freedom, competition and increasing welfare have made EU more and more attractive. This was evidenced in the desire of countries behind the Iron Curtain, suffering under the yoke of political dictatorship, socialism and central planning, to join the EU as soon as possible. And nothing has made the EU and EMU more unpopular than the rise in unemployment, surge in public debt and decline in growth since the crisis began in 2008. It is true that "Europe" is more than growth and money, but without high employment and the prospects of greater welfare, the idea of further European integration has no chance with the people.

Unfortunately, the report adheres to the philosophy that EMU needs more and more centralization of competences at the European level. It is hard to imagine that democracy at the supranational level would be more "vivid" and less exposed to the short-termism of politics that prevails at the national level (Goulard and Monti 2012). For centuries, Europe's strength came from competition among numerous national entities. There are arguments for Europeanizing some competences, but there are also areas where this is not the appropriate way to proceed—and, in some cases, where the existing process of centralization should be reversed. A report concentrating on economics must consider the principle of subsidiarity. Subsidiarity within the EU framework—which governs whether an action should be taken at the European, national or local level—is indispensable for ensuring the functioning of democracy and the support of citizens for the EU.

The report's most dangerous element lies in its ambiguity about achieving additional centralization without changing the foundational TFEU. According to the report, "Greater responsibility and integration at [the] EU and euro-area level[s] should go hand in hand with greater democratic accountability, legitimacy and institutional strengthening." This principle reflects the underlying philosophy in favour of more and more centralization but remains too vague about how it will be achieved.

There are strong indications that the crisis has intensified popular resistance to further centralization. The report seems to acknowledge this by suggesting that such measures should begin only after 2017. (French President François Hollande recently proposed a similar schedule.) It is not unreasonable to suspect that this timing is driven by concern that voters in national elections of the two biggest countries might react negatively to actions toward centralization. This is anything but a signal of the presidents' confidence that Europeans share their ambition. Under these circumstances who would dare to hold referenda on political union?

If there exists a deep reservation among the people against further centralization of competences at the European level, efforts to strengthen EMU (and EU) should instead point in the opposite direction, and national responsibilities should be enhanced. The no-bailout clause is an indispensable requisite of a monetary union comprising states which still insist on their sovereignty, especially as it relates to matters of taxation and public spending. Such an arrangement also needs a non-political control mechanism. Financial markets may not always work perfectly, but they are in the end an indispensable instrument to sanction fiscal profligacy by member states.

An often-heard objection to this idea is that financial markets are a rather inefficient mechanism for keeping states' behaviour in line. Recent experience has provided evidence for this argument, but it is hard to argue that political control has fared better. On the contrary, prior to the crisis there were strong political signals to financial markets that the no-bailout clause would never be enforced within EMU. This misled financial markets and compressed risk premia, which in turn drove the unsustainable boom and misallocation of capital in some euro-area countries. In any case, there is no convincing reason to abandon the current system of control by markets. Those who argue—and there are many of them—that reinforcing the no-bailout clause is illusionary should think about the consequences for the credibility of the whole EMU project, which is based entirely on treaties and commitments. (Not to mention the consequences for the credibility of proposals for far-reaching new treaty elements.) Economically and politically, relaxing the no-bailout clause would open the door for a massive violation of the principle of no taxation without representation, creating strong movement toward a transfer union without democratic legitimation.

It is a fundamental flaw in the five presidents’ report that it does not address the close link between endless violations of the no-bailout clause and the corresponding violation of democratic legitimacy. This is not the basis for a transparent and promising debate on how to secure the future of EMU and the European Union.

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