The Eurozone's Last Hawk

BY JENS WEIDMANN

Tough talk about the long and arduous path to recovery.

About one and a half years after the sovereign debt crisis first came to a head in the spring of 2010, the financial markets and people across the globe are still keeping a close eye on the situation in the euro area. Currently, political efforts are being undertaken to solve the problems associated with the sovereign debt crisis and alleviate its symptoms. However, as the current approach requires ever-more resources, there is a risk that public concerns will increase rather than diminish. Thus, in order to maintain confidence, we have to build a sustainable bridge between short-term crisis measures and a credible and stability-oriented framework for monetary union. What we need is an institutional framework that offers a clear, coherent outlook and provides incentives for the individual parties to act reliably and sustainably. Only with such an outlook in place can the short-term challenges be tackled effectively and the current tensions eased permanently.

To establish the requirements for such a sustainable framework, it is necessary to take into account the peculiarities of European Monetary Union as well as the underlying reasons for the crisis. The sovereign debt crisis was mainly caused by fiscal and economic imbalances in some member states. Ultimately, the combination of a single monetary policy and decentralized fiscal and economic policies proved to be a weak spot in the construction of EMU. In such a union, the incentive for individual member states to incur debt is

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fairly high: If sovereign debt rises in one country, some of the negative repercussions are passed on to the other member states. This problem was already central to the debate when monetary union was founded. Therefore, the founders of EMU imposed rules, such as the Stability and Growth Pact, which aimed to prevent fiscal imbalances from emerging where possible and to correct them where necessary. These rules have obviously failed. Looking at the run-up to the current crisis reveals, above all, a lack of will to implement the rules, which were either circumvented or even actively bent. Thus, sovereign debt was not effectively contained. Together with other factors such as a loss of competitiveness, asset price bubbles, and excessive lending, this led to a strong deterioration of public finances in some member states.

Taking into account the contagion effects that a crisis of public finances in one country might entail for the rest of monetary union, such a situation can compromise the objectives of the single monetary policy. Policymakers might be tempted to call for the only institution able to intervene directly—central banks—to step into the breach and stabilize the situation. Monetary policy certainly does have the tools needed to calm financial markets temporarily. However, applying these tools cannot resolve the underlying problems. Rather, it risks blurring the boundaries between the responsibilities of monetary and fiscal policy and overstretching the mandate of an independent central bank. Also, by supporting individual member states via the central bank balance sheet, monetary policy would redistribute financial burdens between the taxpayers of the different countries. If assistance for individual countries is considered essential for exceptional reasons, such as a threat to financial stability, it must, as a general rule, be provided through fiscal policy. Monetary policy in a monetary union therefore differs crucially from purely national monetary policy, such as in the United States, where there is no danger of having to shunt risks resulting from unsound public finances between the taxpayers of different countries in order to maintain financial stability.

To sum up, the pressing question that has to be answered is how the setup of EMU can be improved to prevent unsound fiscal and economic policies more reliably and to shield monetary policy from their consequences. In essence, the euro area can take two consistent routes to achieve this: the first would be to strengthen the existing institutional framework that governs monetary union. The second would be to undertake a major shift towards a fiscal union.

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Regarding the first route, I do not share the all-too-common view that the existing framework is unsuitable for a monetary union. However, four key adjustments need to

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be made to reflect recent experiences. First, we have to give the Stability and Growth Pact more bite through greater automatism and fewer opportunities for political influence. Therefore, the most recent adjustments of the Pact should be appreciated. Nevertheless, there is still too little automaticity, there are still too many exceptional cases, and there is still too much room for political influence. We have to avoid a situation where potential sinners sit in judgement on fellow sinners. Second, we have to reinvigorate the no-bailout principle. Capital markets will penalize misbehavior of governments only if they risk losing money. Third, we have to make comprehensive changes to financial market regulation and supervision to render the financial system more resilient and to make market participants more risk-sensitive. Only a strong financial system can reduce contagion effects; and these are one of the main reasons why the problems of a comparatively small country have had such serious repercussions for the rest of the euro area. Fourth, given the previously underestimated dimension of increasingly integrated financial markets, we should establish a permanent crisis resolution mechanism for emergencies. Nonetheless, it is crucial to ensure that the specific arrangements do not discard key basic principles such as subsidiarity, individual countries' responsibility for their own fiscal policy, and the no-bailout principle.

Against this backdrop, some of the decisions taken by the euro area's political leaders on July 21 weaken basic requirements for a crisis resolution mechanism based on national responsibility. Above all, one serious cause for concern is the new, looser credit conditions. They will considerably reduce the incentives for countries receiving assistance to make a fast return to sounder public finances. If these conditions were to be adopted for future assistance programs—or even the European Stability Mechanism—such problems would persist. For how can an improved sanction mechanism prevent unsound national fiscal policies if sanctions are threatened but, where rules continue to be breached, protection from the capital market is ultimately granted at extremely favorable conditions—indeed, far better conditions than those for some of the countries providing assistance?

The fundamental alternative to strengthening the existing framework would be to undertake a major shift towards a fiscal union. This would involve a partial transfer of fiscal policy competences to the EU level. However, establishing a European fiscal union would by no means require a complete centralization of fiscal policy. In particular, the principle of subsidiarity implies that wide-ranging competences should remain at the national level. That would help to ensure that the arrangements reflect the preferences of the individual countries' citizens as closely as possible. In my view, it is crucial to set strict deficit and borrowing limits for national budgets at the EU level. These would apply to all levels of national government, including central, state, and local government and the social security systems. The limits would have to be combined with ultimate powers of intervention for the European Union—powers that would have to be extensive enough to ensure that national governments lose their sovereignty over fiscal policy when deficit and borrowing limits are breached, if not beforehand. Consequently, in such a fiscal union, national parliaments would no longer have ultimate decision-making authority over government budgets.

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At this point it has to be emphasized that, contrary to public opinion, such a fiscal union would not necessarily have to entail joint liability. Nevertheless, joint liability could be introduced at a later stage. What has to be avoided, however, is introducing joint liability in the current situation just because a closer fiscal union might be expected. This would imply running before you can walk and thus increase the risk of stumbling. Accompanying the indispensable reforms to restore competitiveness in individual countries, a fiscal union would constitute a consistent legal framework. However, establishing a fiscal union would require far-reaching treaty amendments and also amendments to national constitutions. It would therefore be a long and arduous path to take, and it is unclear whether the people of the euro area would be willing to go down this route.

The decision about which route to take lies in the hands of the euro area's democratically elected parliaments. If this matter is not clarified, the success of the short-term crisis measures will be greatly reduced. The approach of taking the middle road and combining national policy competence with a continuously growing communalization of the resulting risks threatens to be derailed by its own inconsistency and undermines the incentives for sound budgetary practices and economic policies. ◆