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Long Letter, Long Farewell Or the Inevitable United States of Europe

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"More discipline, more solidarity, more responsibility accepted before our peoples and genuine economic government. That is our vision for the future of the Euro Area and future treaty reform."

President Nicolas Sarkozy (1.12.2011)

"But if we shy away from these efforts, are simply just nice to one another and water down all reform initiatives, then we are certainly doing a disservice to Europe."

Chancellor Angela Merkel (26.1.2012)

Europe has still not recovered from the shock waves which roared around the world after the implosion of the US mortgage market. In fact, the Old World has now itself become the epicentre of a new crisis in which the survival of the Economic and Monetary Union is being seen as the issue that will decide the fate of the European Union as a whole. The public debt crisis, which initially began in the autumn of 2009 in Greece, a small country on the periphery of the eurozone, soon started to become contagious. It first spread to Ireland and Portugal, and since then has been inching its way inexorably to the centre. In the meantime the financial markets have pushed up the cost of borrowing for Spain and Italy, which are having to pay much higher rates of interest. The burden of old debt weighs heavily on Italy in particular. If the country can no longer refinance itself, the protective shield set up with the help of the European safety net may very well collapse.

Despite a summit marathon that was unique in the history of the European Union, none of the



measures adopted so far by EU politicians have managed to regain the confidence of investors and international partners. The economic situation continues to deteriorate. Europe is sliding into a recession. And the trend has not been reversed by the most recent Franco-German proposals for an international agreement that would lead to the introduction of a debt brake in all of the eurozone member states. Only a day after the starter pistol for this fiscal compact was fired at the summit in December 2011, Standard & Poor's downgraded the creditworthiness of nine member states in one fell swoop. They included France, which lost its top triple A rating. Without much ado Italy went down two notches to BBB+. Worse ratings were given only to Cyprus and to Portugal and Ireland (both of them had already been compelled to take shelter under the European safety net). S&P justified its move by stating that the EU's crisis management was missing its target, which was to promote growth, and said that cost-cutting measures alone would not lead to economic recovery in the eurozone.

Flying in the face of reason

In the present crisis the EU is paying the price for the fact that for many years the eurozone countries gladly availed themselves of the advantages of the euro, which included low rates of interest on government bonds, whilst at the same time refusing to comply with their obligation to place their budgets on a sound financial basis. Similarly, the considerable differences between the current accounts of the various economies were simply ignored. However, the two components, i.e. fiscal stability and economic convergence, form the precondition for a common currency capable of functioning effectively, especially one which

envisages only very small financial transfers for weaker members via the EU's Cohesion Policy, and which one cannot leave when things are not going well.

Policymakers were aware of this from the very beginning. However, when the common currency was introduced with the Treaty of Maastricht they failed to insert the requisite security provisions to guard against the possibility that they themselves might one day be guilty of wrong-doing. In view of the degree of economic interdependence that existed even in those days, the no-bailout clause that was inserted as a central provision in order to allay fears of "moral hazard" seemed to be out of touch with reality. To exclude any kind of liability of the EU as a whole or of individual member states for the debts of other member states only makes sense if one can exclude the possibility that the insolvency of one member state may spell the ruin of the other member states. At the time many people said that before deciding to embark on monetary union one ought to have taken the idea of "an ever closer union among the peoples of Europe" rather more seriously, and what has happened since shows that they were right. Yet the majority of the member states, and France more than anyone else, may have wanted the euro, but certainly not an ever closer union. Thus all and any plans to establish a monetary union at the same time as a fiscal and economic union were quickly shelved. And so were any ideas that people may have had about a political union. In fact the member states were only prepared to transfer sovereign rights to the European Central Bank (ECB) in the area of monetary union. Economic and fiscal policy continued to be under the control of the member states. They were not prepared to have anyone



above them telling them what to do. Thus they created a common monetary area in which to this day the member states in the Council are at one and the same time their own legislators, prosecutors and judges.

Trust is good, control better

That the politicians would not be able to shoulder these great responsibilities, which is what the design of the monetary union they had created was asking them to do, already became apparent at the time the euro was introduced. They used their discretionary powers to the full, and stretched the convergence criteria included in the Treaty of Maastricht in 1992 until everything finally fitted the bill. On the basis of these criteria states would actually have been allowed to join the monetary union only if their annual budget deficits did not exceed 3% of their gross domestic product (GDP), and if their public debt did not exceed 60% of GDP. Neither Italy, Belgium, nor Greece complied with the last criterion. However, they were granted membership of the eurozone with no strings attached. And the member states adopted a rather lax attitude when it came to the new borrowing criterion. In fact, they became past masters in the use of creative accounting. Italy, for example, won some breathing space with the help of a one-off tax. Germany quickly re-valued its gold reserves. And without batting an eyelid Greece simply falsified its accounts in order to be in compliance with the target deficit.

The heads of state and government were fully aware of the fact that this generous interpretation of the convergence criteria could in the long run create problems for the stability of the euro. Thus in 1995 the member states

reached an agreement in the Stability and Growth Pact (SGP) that they would adhere to the criteria permanently, and not only in the first year of the euro. But permanently did not last for very long. In 2002 Germany exceeded the 3% annual new borrowing limit, and France followed suit a year later. Punitive proceedings should have been initiated in both cases. However, since in the Council the member states themselves decide whether or not they are going to let themselves be punished, and there is no way of appealing against such decisions, Germany and France got away scot-free. This was very much a case of bending perfectly valid European laws, and may in fact have amounted to breaking them. It is hardly surprising that, after this lapse, other member states failed to demonstrate the necessary fiscal discipline, and that it was difficult to do anything about it. In order to preserve at least some semblance of legality, in 2005 the member states actually went so far as to legalize what Germany and France had done retroactively. In the revised version of the Stability Pact the member states granted themselves so many exceptions that in the end the exception in fact became the rule.

And slackness was very much in evidence when it came to the reduction of the economic disparities between the member states, which is equally important for the stability of the euro. It is of course true that the member states, as they were required to do, submitted their stability programmes to the Commission on an annual basis. However, this did not have any real consequences. Even if something was amiss, the response amounted to nothing more than recommendations. And most of these – or so it seemed – were tossed to the wind on the way home from Brussels to



the national capitals. The economic targets may have sounded rather impressive, but they were certainly not binding. With this loose form of coordination the European Union quite clearly missed its goal of becoming the most competitive and dynamic knowledge-based economy in the world by 2010. It also failed to notice or deliberately overlooked the fact that the economic boom in Spain, Ireland and Portugal was no more than a bubble which, as we now know, burst the moment that the flows of cheap credit dried up.

Not only the symptoms

The cavalier attitude to European law which became apparent in the early history of the monetary union is now making life difficult for the countries of the eurozone. They would no doubt have been able to cope much better with the banking and financial crisis that erupted after the insolvency of US investment bank Lehman Brothers if prior to this they had adhered to the rules. This is something the politicians simply cannot deny. And more or less everyone was a failure in this regard. After all, the GIIPS states, which tend to be given much of the blame nowadays, were not the only sinners. Germany and France were just as bad.

But today Germany and France and their “Merkozy” rescue team are seen hurrying from one crisis summit to the next and launching one reform package after another. Many of the other member states follow them unwillingly. They dislike their leadership style, and the one-sided focus. The measures that they have managed to introduce so far are virtually all in the area of fiscal policy.

From now on the member states will have to submit their annual budget plans to Brussels as part of the “European Semester” procedure so that they can be vetted before the budgets are passed by the national parliaments. This is supposed to be a preventive measure that will put the lid on new borrowing. Furthermore, the European “Six-Pack” legislative package not only retracts the weakened deficit procedure adopted in 2005, but also introduces new safety catches and punitive sanctions. It will now be easier to punish infringements and to impose stiffer penalties.

However, no significant improvements have been made with regard to the second pillar, economic and social policy. One or two screws have been tweaked in order to improve coordination when it comes to the reduction of macro-economic disparities. However, this has not got to the heart of the problem. As a result the financial markets have reacted in a lukewarm manner or even negatively.

The situation has been defused to a certain extent by the establishment of a safety net, the “European Financial Stability Facility” (EFSF). Its loans are backed by guarantees from the member states. Hitherto Ireland and Portugal have received favourable loans, though these are tied to strict spending cuts. The EFSF is a temporary measure, and is going to be replaced by the “European Stability Mechanism” (ESM). Instead of unanimity, an 85% majority is all that is needed when it comes to deciding whether or not to give a loan to a country which has asked for financial assistance. The structure resembles that of the International Monetary Fund (IMF), though, as the name suggests, it



cannot function as a genuine European Monetary Fund. After all, the no-bailout provisions of the treaties continue to be operative, and thus neither member states nor the EU can be held liable for debts incurred by others. And the monstrous names which were devised for the EFSF and the ESM are merely a rough and ready way of concealing the fact that in terms of contract law the member states are operating on very thin ice. The EFSF exists only because it was established as a private special purpose vehicle incorporated under Luxembourg law and is not part of the European legal framework. On account of the pressure of events, the start of the ESM has been brought forward to the middle of this year. It is already becoming clear that the €500 billion which it can provide in the shape of loans will not be enough in the light of the worsening economic crisis. Further negotiations are due to take place in March 2012.

All other reforms that have hitherto been initiated are concerned with what may or may not happen in the future. It remains to be seen whether this will make it possible to prevent crises from breaking out in the years ahead. The “Six-Pack” merely breaks the member states’ power of veto at the very end of the deficit procedure. For this purpose a new voting rule has been devised, and this is clearly a masterpiece of European treaty-making. It does no more and no less than to curtail the sovereignty of the member states without in fact curtailing it. In future punishment is going to be meted out by the Commission in an automatic kind of way as long as this is not overruled by a qualified majority of the member states.

However, the efficacy of this reformed voting rule is limited. It can be used only under

certain circumstances, and the crucial decision of whether an overly large deficit that warrants the imposition of sanctions actually exists in a certain member state will continue to be made by the Council on the basis of the original voting procedure. The only thing about which there can be no doubt in view of the majorities and the distribution of power in the Council is that Malta would not be able to evade punishment.

And when it comes to improving convergence in the eurozone the emphasis is still on voluntary cooperation. The term “economic government” thus exaggerates what these reform packages actually contain. EU “intervention” in national economic policy is not on the cards. It is to be hoped that the member states have learnt something from the euro crisis, and that in future (in contrast to the past) they will adhere to joint targets designed to improve their competitiveness. None of this is legally binding. For this reason the member states do not have to fear the consequences if they either do not or only partially implement the promises they made in Brussels. However, it may well be possible that the significantly expanded and far more sophisticated steering and coordination procedures, which include new kinds of early warning systems, will keep the member states on the straight and narrow. They will have to report back more often. And far more stringent demands are going to be made on the reports which have to be submitted to Brussels. This will probably lead to more transparency and raise the level of peer pressure. However, the politician who is willing to risk his chances of being re-elected for the sake of Brussels has not yet been born.



Fiscal toing and froing

The politicians themselves are most keenly aware of the extent to which domestic policy constraints influence their decisions on the European level. They have been elected first and foremost to defend national interests. This means that from time to time their interests will clash with the interests of other member states or with the supranational interests of the community as a whole. For this reason they can easily succumb to the temptation to interpret European rules in what for them is the most advantageous way or to ignore them, even if this is detrimental to the European cause—and in this case the euro.

Germany in particular, which in the sovereign debt crisis is being asked to do more than anyone else in financial terms, thus deemed the rules that have been devised to persuade the member states to consolidate their budgets to be insufficient. For this reason Germany and France, at the European summit on 8-9 December 2011, suggested that there should also be a fiscal compact for the purposes of mutual reinsurance. The agreement will be concluded at the forthcoming European Council in March 2012, and the heads of state and government will be putting the finishing touches to the draft agreement at the special EU summit on 30 January 2012.

In order to create a Stability Union, all of the countries in the eurozone will undertake to follow the example of Germany by inserting a debt brake in their constitutions or by adopting similar laws of a constitutional nature. Thus annual new borrowing will not be allowed to exceed 0.5% of nominal GDP. If this happens nonetheless, it will be counteracted by a “corrective mechanism” which is triggered

automatically. The correct incorporation of this commitment into national law can be ascertained by the European Court of Justice (ECJ) if it is petitioned to do so by a member state. It is unclear what will happen if the ECJ comes to the conclusion that a country is not in compliance with its duties. At any rate the whole issue still leaves a lot to be desired.

On top of this only member states which have adopted a debt brake will be able to obtain loans from the permanent ESM safety net. Thus states which in future may wish to avail themselves of European financial assistance will first of all have to implement the fiscal compact.

Moreover, old debts which exceed the 60% SGP limit must be reduced by 5% annually. There are as yet no regulations specifying how this is to be implemented and controlled, and how sanctions can be imposed.

Furthermore, the agreement also seeks to tighten the control function of the deficit procedure and makes it possible to impose sanctions if a member state does not adhere to the 3% limit. Thus the Commission is not only going to have the power to initiate a deficit procedure as envisaged by the “Six-Pack” stability provisions. It is now also empowered to make a formal decision concerning the existence of an excessive deficit. Moreover, the sanctions procedure in cases of alleged infringement can also be set in motion by the Commission. Yet the final say in the matter is still in the hands of the member states, which can reverse a Commission decision with a qualified majority vote. The fundamental weakness of this sanctions and controls regime may have been reduced, but it has not



been abolished. But at least the member states will find it more difficult to evade their responsibilities.

At first sight it would seem to be a good idea to try to attain greater budget discipline by taking a roundabout path via the national constitutions. However, the fiscal compact does not provide cast-iron security. In the final analysis it lies in the nature of sovereignty to refuse to be restricted and bound by international law, which is what this agreement tries to do. Thus the implementation of robust budgetary rules and regulations is still very much at the mercy of national policymaking.

How to relinquish sovereignty

The problem in a nutshell is the refusal of the eurozone member states to limit their sovereignty (although it would be in everyone's interests) and to submit to automatic and binding (i.e. legally enforceable) controls. As long as this state of affairs persists, the chances for the future in the eurozone are rather negative. And even if the politicians have been very badly shaken and are prepared to surrender more sovereign rights to the EU level, this is not possible without further ado.

The Treaty of Lisbon, it is true, places at the disposal of the member states what is known as the "simplified treaty amendment procedure." However, the member states made sure that the procedure was clearly circumscribed. First, it may be applied exclusively to legal areas in which the EU already possesses legislative powers, i.e. where it can actually introduce changes via secondary law. Second, in the European Council unanimity is required even in the case of the simplified

procedure. However, reaching a consensus with regard to questions relating to the economic and monetary union is very difficult. The members of the eurozone, the accession candidates, and the countries which have decided not to introduce the euro simply have very divergent interests. This was demonstrated once again by Britain's "No" at the most recent summit of the European Council held on 8 and 9 December 2011.

Every other additional step towards more integration which either enhances EU competences that already exist or creates new competences can be taken only by altering the treaties on the basis of the "normal treaty amendment procedure." This is also what has to be used whenever the institutional structure of the EU is being reorganized and new tasks are being assigned to the various EU bodies. An example of this would be if the European Commission were to be empowered to punish infringements by the member states against the rules governing new borrowing at once and without a prior Council decision.

The procedure is rather convoluted. Moreover, the duration and the outcome are uncertain, as was demonstrated by the referendums in France and in the Netherlands after the European Convention, and by the Irish ratification debate on the Treaty of Lisbon. It is of no use whatsoever when it comes to swift and determined crisis management of the kind that it currently required.

First of all the European Council, after consulting the European Parliament and the Commission, would have to decide by majority vote that it actually wanted to change the European treaties. Then there would have to



be a European Convention at which representatives of the national parliaments, of the heads of state and government, of the European Parliament and of the Commission drew up a new draft treaty. Subsequently this draft would have to be adopted unanimously at an intergovernmental conference. And, last but not least, the new treaty would have to be ratified by the national parliaments. In a number of member states the law relating to the ratification procedure also makes it necessary to hold a referendum.

Still a long way to go

On account of their obsession with sovereignty policymakers have made two major mistakes. First, they are responsible for the desolate state in which the eurozone finds itself. And they are responsible for the fact that it is practically impossible to change the treaties quickly. It is in fact difficult to secure a greater degree of reliability without going through the treaty amendment procedure. But greater reliability is what is needed in order to surmount the decisive obstacles and thus to resolve the euro crisis. Furthermore, reliability is what is needed in order to ensure that the euro is not going to be rescued at the expense of following generations. History tells us that “moral hazard” is an omnipresent and recurring feature of policymaking.

The euro crisis cannot be resolved by simply hoping that it will go away. For the countries that have been hit hardest there is not the slightest chance that they can overcome the crisis by tightening their belts. But even the top of the class will face a hard time: Who is going to buy their goods if no one can pay for them? 42% of German exports go to the eurozone. In other words, in addition to the

unavoidable spending cuts and painful (though necessary) economic reforms, at the end of the day it will be impossible, when it comes to the question of debt, to avoid some kind of communitarization.

Several proposals have been made with regard to the issuance of eurobonds, and the Commission has now published a green paper on the subject. The *“German Council of Economic Experts”* has come up with a plan (which many people think is a good idea) to create a joint *fund* that would help to reduce the level of debt for a limited period of time. Other people are in support of more radical solutions and have come out in favour of the “big bazooka.” This means that the ECB would be able to issue its own bonds and to buy up bonds from the member states. It may well be that the strict German kind of monetarism, which believes that a central bank has one task, and one task only, i.e. monetary policy, is out of date. But it is not possible to remodel the ECB on the lines of the US Federal Reserve System, or to empower the EU to issue eurobonds, at least in a legally impeccable manner, without introducing fundamental changes to the European treaties.

The first thing that would have to go is the no-bailout clause, and that would be the least of our worries. In point of fact the whole section on economic and monetary union ought to be revised, and there should be a new section of the treaty relating to the foundation of a fiscal union. A genuine European economic government would take the place of the convoluted coordination procedure. And whilst they are at it, the heads of state and government could actually go the whole hog and give the European Convention a mandate



to draw up a constitution for the United States of Europe. After all, in the absence of a political union it is difficult to justify intrusions into the budgetary sovereignty of the member states. It should not be forgotten that when one embarks on a transfer union it is not only of importance to determine how much states are permitted to borrow and how they intend to repay their debts, but just as important to ascertain what they are borrowing for. In this respect we are still very much at the beginning of the debate.

Conclusions

The EU is caught in a cleft stick. On the one hand the euro crisis will be difficult to resolve without the communitarization of debt and a credible transfer of sovereignty. On the other hand neither can come about unless the European treaties are amended in a legally impeccable manner. What is actually needed is a grand gesture, such as the establishment of the United States of Europe, if, that is, the member states want to be completely sure that in future the rules of the economic and monetary union will be adhered to for the benefit of all. But that takes time, and time is something that the financial markets are not going to give them.

The story goes that Konrad Adenauer, one of the founding fathers of European integration, once said that “the situation is serious, but not hopeless.” Of course, it is difficult to say whether Adenauer would repeat this witticism today in view of the fact that the European Union seems to have got bogged down in an impasse.

However, it is in the nature of politics—and that is what Adenauer was trying to say—that one does not give up. For this reason we are now

seeing how the heads of state and government are putting their heads together in order to raise the level of reliability as far as they can without amending the treaties. This at least is going to make it possible to increase the size of the European safety net. And it may also enable the ECB to define its mandate in a more comprehensive kind of way, allowing for larger-scale purchasing of government bonds on the secondary markets or for more liquidity of banks by providing them with additional loans amounting to billions of euros.

That is not a perfect way of doing things, and it does not look very good when seen from the terraces. But it is politics, and in politics (and especially in European politics), which in a profound democratic sense is based on compromise, there are no perfect legal solutions, and there are no perfect economic ones either. This does not mean that policymakers should be able to do as they please, and it does not mean that they should be allowed to succumb to timidity and inactivity. The crisis has demonstrated that in the long term we will have to turn ourselves into the United States of Europe.

However, if for the time being this is not within reach, then at the very least we need a viable temporary solution. This would include the speedy transfer into European law of the financial stability measures that are being set up beyond the framework of the European treaties. Moreover, budget consolidation should be complemented by a strategy for growth, and in this context the Cohesion Policy that has existed hitherto should be subjected to critical scrutiny. This could well be done in the course of the current negotiations on the next multiannual EU budget.

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