Towards a New Monetary Constitution in Europe
The Proposal of the German Council of Economic Experts (GCEE)

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I. Continuing Surprises

After the announcement of Mario Draghi, the ECB president, to do "whatever it takes" to preserve the integrity of the European Monetary Union (EMU) in July 2012 and the establishment of the Outright Monetary Transactions (OMT) program in September 2012, the crisis of EMU is far from being resolved. The recent developments after the Italian elections and the troubles around Cyprus have shown that each negative surprise calls into question the measures hitherto adopted. Still, investors appear to view the OMT program as credible such that no turmoil followed the Italian and Cypriotic surprises.

A more severe problem might emerge, however, if the German Constitutional Court's decision on the European Stability Mechanism (ESM), the Fiscal Compact and the OMT turns out to be negative. The ESM and the Fiscal Compact have already passed as constitutional in September 2012 in an urgency decision. No surprises should be expected in this regard. But the Court has not yet decided on the OMT. The main decision will be expected in autumn 2013 and it is possible that the Constitutional Court states a violation of the ECB's mandate by the OMT – with uncertain consequences as to what the German government would then have to do.

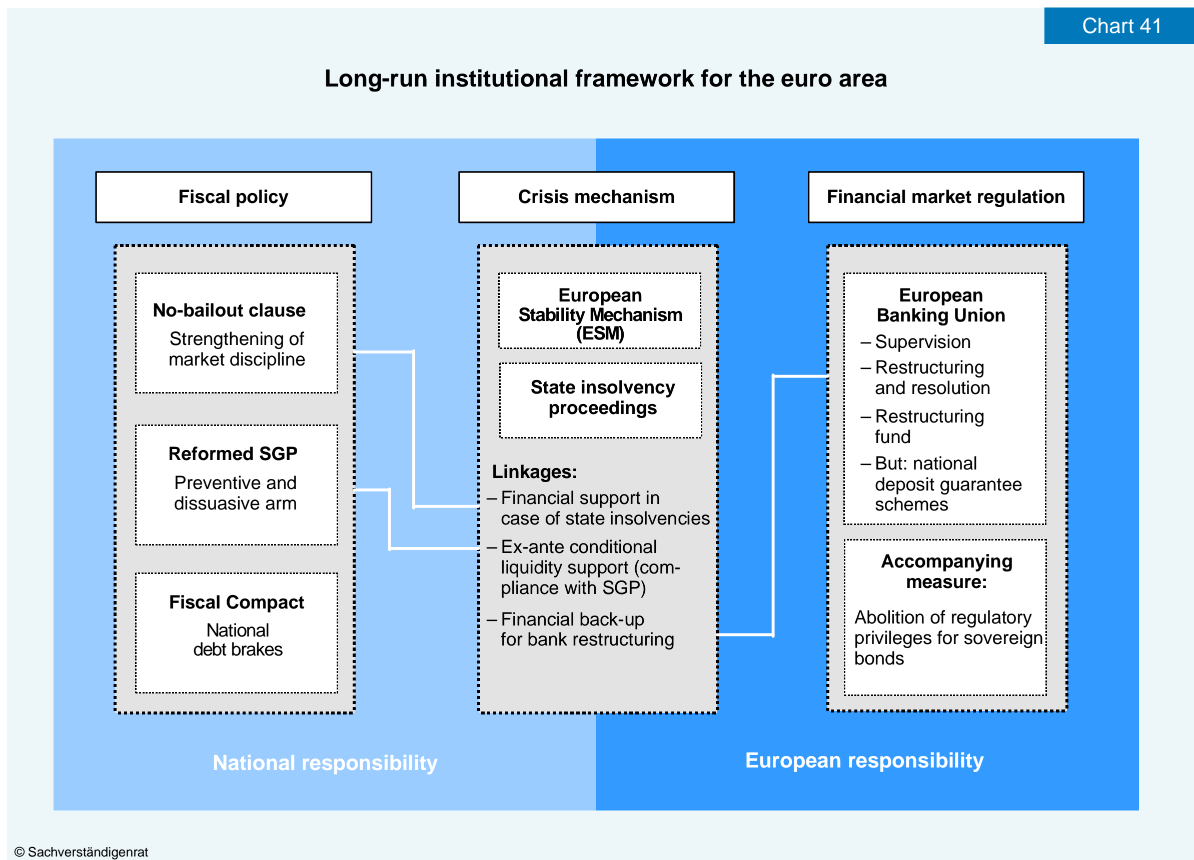
The German Council of Economic Experts (GCEE 2011, 2012a, 2012b) has developed a framework for EMU that addresses the flaws of the Maastricht and Lisbon Treaties. This framework has been carried by the insight that monetary policy can only buy time, but is unable to actually resolve the Eurocrisis. The proposal by the GCEE thus aims at suggesting an alternative that enables the ECB to resign from some of the current responsibilities and concentrate on its main goal of price stability.

II. Maastricht 2.0

The GCEE has called its framework Maastricht 2.0. It starts from the long-term vision of how EMU should look like and then adds the European Debt Redemption Pact as a mechanism to build a bridge between the current crisis and the new monetary constitution in Europe. The long-run institutional framework is summarized in Figure 1.

The financial crisis and the Great Recession have revealed that the main problem of the old EMU framework was its negligence regarding financial markets and the banking sector. The no bail-out clause and the prohibition of monetary financing of fiscal policies establish national autonomy and responsibility of EMU member states. This principle also holds regarding general economic policies unless explicitly specified otherwise in the Treaties. Financial market and banking regulation have remained in the national jurisdiction also. After a severe financial crisis that leads to a banking crisis the no bail-out clause is not sustainable without further endangering financial and economic stability. A credible re-establishment of

the no bail-out clause thus requires a banking system that is better able than before the crisis to absorb severe shocks. The key element of Maastricht 2.0 is the European banking union.



However, in order to arrive at a more sustainable framework for EMU, a fiscal union is not necessary. A larger budget at the EU level that could perform as a macroeconomic stabilization device is fully replaced by large budgets of member states which they can use for countercyclical fiscal policy if this is necessary and if it is useful (which is not often the case). Member states are up to the task of discretionary fiscal policy if their public debt is sufficiently low before a crisis hits. This insight has led to the Stability and Growth Pact. A permanent mutualisation of government debt in Europe provides adverse incentives for member states to consolidate their public finances and continuously establish sound public finances. If such a mutualisation is not accompanied by a strong European authority, say a European currency commissioner that actually works as European finance minister, to interfere in national budgetary decisions, Eurobonds will only postpone the necessary fiscal consolidation and induce a more severe fiscal crisis in the future that would then possibly surmount the ability of the stronger member states to help others out.

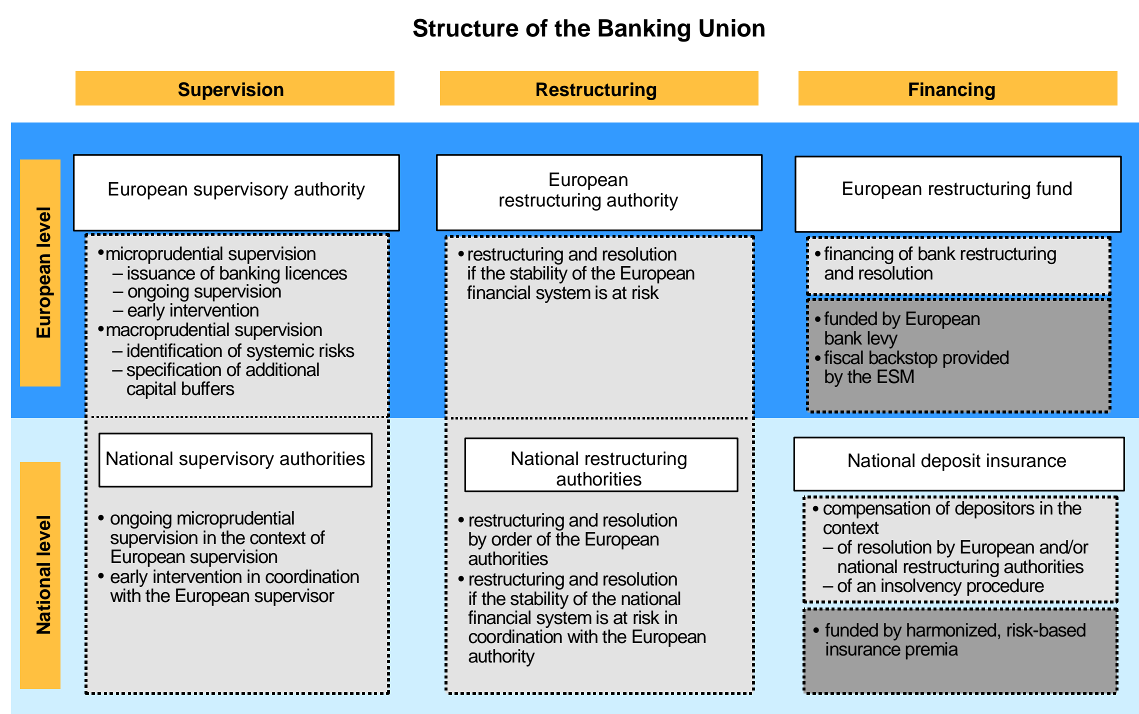
Aside any legal or constitutional problems such a European budgetary authority would pose, it would also not be credible unless this authority were allowed to interfere in the national implementation of national budgetary policy. Otherwise, member countries could make a budgetary decision in parliament officially complying with EU mandates, but then deviate from it during implementation. Such jurisdiction will only be available in a unitary state and it runs against the experience of existing federations. Those federations that are most successful – the U.S., Canada, Switzerland – have established full fiscal responsibility and autonomy of their sub-federal jurisdictions. Federations like Germany or Austria, not to speak of Nigeria or India, which have not followed this assignment of competencies, have troubles of excessive debt at the sub-federal level. The EU will never be and should not be a unitary state. It will be

a federal state or it will never become a state. And it is to be recommended to follow the role models of the successful federations rather than those with excessive indebtedness.

Thus, the GCEE's proposal for the new monetary constitution in Europe does not touch upon the no bail-out principle already established in the Maastricht Treaty. It rather complements it with a crisis mechanism – the ESM – that could be enhanced by provisions for state insolvency proceedings after the debt to GDP ratios of member states are below the level of 60 percent of GDP. This enhancement would lend higher credibility to the no bail-out principle.

III. Corner Stones of a Banking Union

In contrast to fiscal policy, the GCEE proposes to establish a banking union in Europe which should comprise a European supervisory authority, a European restructuring authority and a European restructuring fund insured by the ESM as fiscal backstop. The European authority in financial market and banking regulation would allow for fixing the flaws of the Maastricht and Lisbon Treaties, to end their negligence with respect to financial markets and to force European banks to be better prepared for future financial and economic shocks. The structure of this proposal is summarized in Figure 2.



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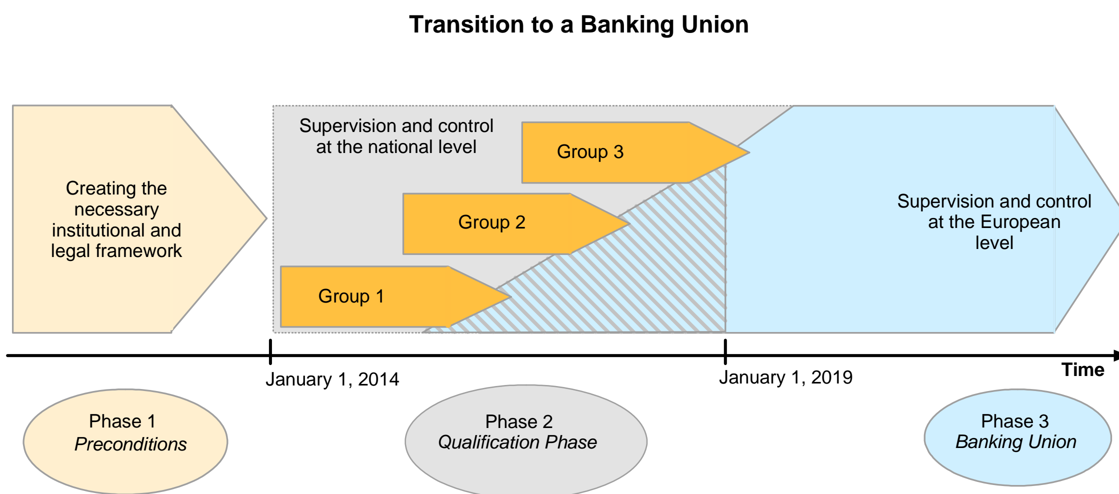
Regarding supervision, the proposal suggests to establish a unified, EU-wide banking regulation which is supervised by an independent European authority that supervises *all* banks in Europe, but is not a part of the ECB. It is preferable to establish the European restructuring authority in the same institution because supervision might reveal the necessity to restructure or even shut down banks. This restructuring authority must be able to act quickly. A distribution of supervisory and restructuring authorities to different institutions may then cause transaction costs that prevent the authorities from reacting in appropriate time. The restructuring authority must be democratically and legally checked. It can thus not have the

same extent of independence as the ECB. Moreover, the ECB would face a trade-off between financial market supervision and price stability. National supervisory and restructuring authorities complement the European authorities.

The restructuring authority needs a liquidity mechanism, a restructuring fund. According to the proposal by the GCEE this should be funded across time by a bank levy. Existing national deposit insurance funds should not be centralized. Also, the ESM should not be allowed to finance banks directly unless the banking union is fully established. The GCEE has proposed a slow transition towards banking union as outlined in Figure 3. This timetable may still be ambitious. At each step, risk and liability remain at the same level of political or regulatory decision-making ensuring that no moral hazard occurs. This timetable underlines that a European banking union is not a quick fix for the ongoing Eurozone crisis.

Transition to a Banking Union



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IV. The European Debt Redemption Pact (ERP)[1]

The long-run institutional framework will not be obtained without bold action in the current crisis that prevents EMU from collapsing. Until now, the ECB has taken the lead. There are two reasons why this solution should not be permanent: First, the ECB runs the danger to violate its mandate and thus to create inflation potential with excess liquidity that is politically difficult to correct when inflation expectations rise. Second, the ECB cannot directly impose conditionality on member countries the bonds of which it buys under the OMT program; it rather needs a fiscal authority like the ESM to enforce conditionality and induce member states to continue their consolidation efforts and their structural reforms.

As an alternative crisis mechanism, the GCEE has proposed the European Redemption Pact (ERP) as a fiscal solution. It features limited joint liability – limited both in amount and time – in the European Redemption Fund (ERF) and is complemented by strong safeguards to complete the European Redemption Pact. The idea behind it is that joint liability is provided in exchange for collateral. According to the proposal each country which is not already in a

[1] For this summary of the European Redemption Pact (ERP) see GCEE (2012b). It is developed in more detail in GCEE (2011, 2012a).

program – Greece, Portugal, Ireland and Cyprus are not part of the fund – should be allowed to refinance through the ERF the difference between its actual debt to GDP ratio and the 60 percent ceiling laid down in the Maastricht Treaty. Despite this refinancing, each member country remains the legal debtor such that a failure to serve the obligations in the ERF amounts to a default on all government debt. The ERF issues own bonds with joint and several liability. The total joint liability would amount to roughly 2.6 trillion euro on the basis of the data available until the second quarter of last year. It will meanwhile be higher due to fact that debt-to-GDP ratios in most of the countries which could participate in the ERF have risen more strongly last year.

This amount would accumulate after the end of a roll-in phase of up to six years, until new bond issuances for each national amount end. During the roll-in phase the consolidation efforts and structural reforms demanded from the member countries in return for this solidarity can be convincingly initiated. Once the roll-in phase has been completed, the redemption phase of around 25 years would begin, during which the fund volume would gradually be reduced, such that by 2038 all the bonds issued by the ERF will have been redeemed.

As the GCEE (2012a) explains in detail, the ERP requires member countries to provide collateral. Possible safeguards include amongst others:

- Ex ante implementation of a credible national debt brake (controlled by the ECJ also in its contents) to underpin the credibility of the consolidation commitments,
- Consolidation agreements which explicitly state how the individual member states will cut their structural budget deficit to a maximum of 0.5 percent of GDP during the transition period,
- The obligation to specify certain (if necessary new) taxes that will be earmarked for paying interest and redemption payments, and
- The posting of collateral amounting to 20 percent of the outsourced debt. This could be, for example, a country's foreign currency and gold reserves, and member states could additionally provide covered bonds as collateral. These would be surrendered if a country failed to meet its payment obligations.

After the redemption period ends, the debt ratios of all members states will be down to the reference value of 60 percent and the conditions to move forward to Maastricht 2.0 will be met. It would then be possible to rely on national liability, to establish a state insolvency mechanism and to trust in the disciplining function of the markets.

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