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EMU 2.0 and the German Problem

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The most common comment on the Brussels Agreements of June 29 concerning the reform of the European Monetary Union (EMU) is that they are the first step in the right direction, but sill insufficient. The market's cautious reaction seems in the same tone. The direction is right, and corrects previous mistakes, for two reasons. First, the Agreements recognize that no mid-term fiscal consolidation plan can be undertaken under the present emergency conditions; firewalls are necessary immediately in order to stabilize sovereign debt spreads and break the tie between banks and governments. Second, the Agreements also pave the way to the demise of the EMU as it was designed by the Maastricht Treaty and the Stability and Growth Pact. EMU 2.0 will need more common fiscal policy, not only fiscal police, that is, a Union's Fiscal Authority, with democratic legitimacy, on top of a New Pact based on a clear, consensual and contextual exchange of fiscal discipline for fiscal solidarity. As a matter of fact, all this also certifies that the two-stage strategy so far pursued mainly by Germany – fiscal discipline now, fiscal solidarity (maybe) tomorrow – is not working and is not taming the investors' fears. The problem is: Will this first step be followed by others? Will the reforms foreshadowed in Brussels become reality? Many "technical" aspects remain to be settled, but behind the technicalities the key issues concerning EMU 2.0 are essentially political, and the suspect is strong that the political game is not over.

From this viewpoint, I see more reasons for pessimism than optimism. New political leaders in Greece, Italy, Spain, seem willing and determined to reform their countries consistently with the requirements of EMU 2.0. Uncertainty about their success is legitimate, but uncertainty about their counterparties' will is legitimate as well. The narrative of the EMU crisis in the countries that feel virtuous boosts strong political pressure to the effect that all the responsibility and the burden of adjustments fall onto the shoulders of those they see as fiscal profligates (aka PIIGS). Let financial markets do their job freely and give a hard lesson to the PIIGS. The EMU as it is will work well when the PIIGS will be redeemed – even better if the PIIGS give up. Germany is playing an enigmatic role in this plot. Does Germany really want the EMU 2.0 envisaged in Brussels? Is Germany ready to do its own part? Because if EMU 2.0 is to be born, not only the PIIGS, but also Germany has a lot of hard homework to do.

Germany's homework is not on the grounds of economic reforms, where Berlin can teach a success story, but it may turn out to be no less, maybe more, challenging. For Germany, viewed from outside, appears unwilling, or uninterested, or even *unfit*, to be the founder, let alone the leader, of EMU 2.0. Its political class in power (majority and opposition) lacks the necessary leadership to overcome internal resistance, its institutional structure is extremely rigid against any external contamination, the nation as a whole seems affected by an identity and vocational crisis regarding its future in Europe (e.g. H. M. Trautwein, Nel Merito, October 14, 2011). So the EMU lives suspended in a stalemate: nothing can be done without Germany, nothing can be done with Germany. At the end of a long column full of moralistic considerations about debts and austerity published by *La Repubblica* (July 1, 2012), Thomas Schmid (*Die Welt*) made the true point: Is Germany ready to exert its *hegemony* for the good of Europe?

Hegemony

Germany's spokes(wo)men transmit the idea that the nation is doing its best to accomplish its exclusive mission for the good of Europe: to be a model of economic virtues and save the Continent from fiscal profligacy by prescribing massive doses of "austerity" to the ill peoples. What else? Alas, the medicine is not working; yet the wrong medicine is never enough, so that the ill, and the EMU, will die waiting for *Godot*. Hegemony is a different matter.

This was a category (re)introduced into the international relations political-economic debate in the Sixties and Seventies, when it became synonymous with "soft power" exerted by the hegemon with some degree of assent from its "subjects". The secret of hegemony lies in the hegemon's ability, and willingness, to produce "common goods", such as peace, security, assistance, orderly economic relations, in exchange for the "golden share" in all relevant decisions conferred upon it by the "subjects". This golden share enables the hegemon to pursue its own national interests (to some extent), and makes it sure that no decision will ever be taken that may hurt them, but it comes with a cost. *The cost of producing common goods*, first and foremost the stability of the system. These may be direct economic costs, but also, if not more importantly, *the constraint self-imposed onto the menu of policy options*, which cannot be chosen irrespective of the effects they exert on the "subjects". The Marshall Plan was the first instalment to pay, followed by many others, for America to become the hegemonic power of the Western World. And this hegemonic equilibrium began to falter as the US tended to abuse its golden share as a source of privilege or failed to deliver the promised common goods (the classical example is the abuse of the dollar as the world currency and the break-up of the Bretton Woods system).

It is obvious that EMU 2.0 will never see the light if we have to wait for the United States of Europe. A realistic EMU 2.0 will resemble a Super Bretton Woods, that is, an intermediate relocation and dislocation of powers across national governments and super-national institutions in which such categories as hegemony and leadership will be crucial. And here is the German Problem – or, as Martin Wolf puts it, the German Riddle (*FT*, May 31, 2012).

Sins, debts, moral hazard, and all that

Let me start from the most popular feelings surrounding EMU 2.0. The Germans say that sharing fiscal risks with the PIIGS is not acceptable, not at least until the PIIGS are redeemed. Yet the true story of the crisis is that big macro-shocks and fiscal risks are pervasive in the global economy regardless of national sins and virtues. No monetary union can survive if all members must be alike and the sun always shine. Thus, contrary to the illusions of the Maastricht zombie doctrine, fiscal risk sharing is a fundamental pillar in a sound monetary union.

True, any insurance scheme pools together good subjects and bad subjects, and on average the former pay for the latter. Nonetheless, economics says that paying for insurance is rational for (self-interested) risk-averse people. Either the German median voter is a risk-lover or commits one of the sins of irrationality that are largely studied in the under-insurance literature – such as overconfidence ("it can't happen to me"). It is also true that insurance elicits moral hazard. But if moral hazard made insurance impossible, as it is often presented by German policy makers, insurance companies would have disappeared a long time ago. All the various proposals of fiscal risk sharing on the table address the moral hazard problem and include instruments to manage it. Clearly, there should be something deeper, and worrisome, behind the German fuss about moral hazard and all that.

Morality, economic policy and politics

Another bit of insurance psychology warns that knowing who the bad subjects are does not help (the proverbial "veil of ignorance" is important). Yet, imagine that in the aftermath of World War II, President Eisenhower decided to ask US taxpayers whether they were eager to forgive the war debts of Germany and its allies, and to transfer them a huge amount of government aids in order to help their social and economic recovery, to foster their rapid return to democracy, and to tie them up in the new Transatlantic Alliance. Was such amazing forgiveness *moral?* How was it possible?

Those were times in which economic policy was the attendant of Big Politics, or so it was understood and practised by the new post-war political élites. Granted that morality was not perceived as a category with immediate economic relevance, it was the morality, or more concretely the superior interest of major political ends, that would enlighten economic policy means. That was not always for good. But with more (Continental Europe and Japan) or less (Latin America) fortunes for the involved peoples, that was the framework within which the new political-economic order was reconstructed under the American hegemony.

Germany possesses all the characteristics to be the natural hegemon of Europe; and to some extent it has the vocational attitude to play such a role. However, Germany has often appeared an "economic giant and political dwarf", one step behind the full endorsement of the onus of hegemony. Helmut Kohl as founding father of the euro was of course one of the exceptions.

It's politics, stupid

No serious political leader may be unaware that the euro was born as a catalyst of the deepening of the EU. It was economic policy at the service of Big Politics. Serious economists, too, should take note of this, whether they like it or not. The German green light for the euro in exchange for Reunification was integral part of this design. But the Bundesbank did not like this submission of its own economic policy to Big Politics and started a war of attrition with the government for the huge fiscal transfers to the Eastern brothers resulting in a dramatic upsurge of interest rates (today nobody seems to remember that in 1992 the interest rate on *Bunds* was around 8%). A by-product was the break-up of the European Monetary System as the periphery started to finance Germany with massive capital flows (another oft-forgotten "detail"). Maybe the Bundesbank was faithful to the historical tradition of Germany's "Mercantilist Monetarism", as dubbed by the historian C. L. Holtfrerich. However, systemic destabilization induced by the prevalence of internal interests or conflicts is precisely what a hegemon cannot afford to do.

Today we find ourselves in a similar situation with reversed roles, with the periphery in the need of large external refinancing, while Germany seems under a new attack of vocational crisis. Once again, part of its most influential establishment seems totally inward-looking, and unaware of Germany's co-responsibility for the political dimension of the euro and the implications of its break-up. The case of Greece is emblematic. Does anybody in Germany care that pro-Europe moderate parties are falling apart to the advantage of anti-Europe extremists of all sorts? Is the contagion of these viruses not so important as the financial one? In brief: Germany should decide if it wants to play a European cooperative game all across the board, as is due by a hegemon, or a non-cooperative game like any ordinary small *Heimat*.

The notion of cooperation makes Germany's spokes(wo)men very nervous and vocal about the costs the nation bears in and for the EMU. But this argument needs much more careful analysis. In per capita or GDP terms, Germany's official current and capital transfers are no more, sometime less, than those of other smaller or peripheral countries (Credit Suisse Report, *La Repubblica*, June 24,

2012). The sovereign debt crises at the periphery have also offered good deals to the core country, such as the carry trade with the Greek loans, or the negative real interest rate paid on public bonds (i.e. a real tax levied on international investors). Yet there is something more important in a long run perspective.

As a matter of fact, the design of the EMU was a German success since it perfectly fitted the tradition of "Mercantilist Monetarism". Fixed parity with outlet markets, tight monetary policy and competitive wage deflation have created the ideal grounds for Germany's stellar export performance over the last ten years. If this is the EMU "economic order" that Germany likes the most, then it is a basic economic law that the counterpart of it is the refinancing of net importers. Indeed, a similar US-based economic order emerged from World War II, but the US did not complain about its capital transfers abroad or its large shares in the costs of the international institutions. Of course, net importers cannot be such forever, nor can net exporters. Hence, the US negotiated to design the Bretton Woods system to make that order sustainable with in-built mechanisms aiding smooth adjustments of external imbalances, and providing a hedge against the tragedy of the interwar competitive deflations for being all exporters. The Berlin consensus seems to be pushing Europe back in the opposite direction (N. Ferguson, N. Roubini, RGE June 11, 2012).

Sovereignty devolution. Really?

Official statements of the German Chancellor require some tangible fiscal sovereignty devolution as a credible commitment to EMU 2.0. This is a sound principle on which everybody seems to agree, although at this stage it remains quite vague, so vague that all the parties involved may have in mind different things. Popular scepticism falls onto France, notoriously jealous of national sovereignty. But, what does Germany really have in mind?

Kohl, after Reunification, promised a European Germany, not a German Europe. As a matter fact, Germany (more than France or Italy) appears a very rigid institutional, "identity" structure safeguarded by the Supreme Court in Karlsruhe (E. Parisi-Capone, RGE July 12, 2012). Their leading "Ordoliberal" principle seems such that no institutional contamination from "outside" can be admitted if in contrast with Germany's established architectural order. Hence, what Germany has in mind when talking about sovereignty devolution may be either devolution to existing *status-quo* institutions (namely the Commission and its technocrats) or to a new institution which cannot but replicate the same decisions that an equivalent German institution would take (a carbon copy of the German Minister of Finance would perfectly fit so as the ECB should be a carbon copy of the Bundesbank). But neither option corresponds to what is generally meant by a common Fiscal Authority, let alone a Fiscal Union.

Brief conclusion

The capital sin for a would-be hegemon is to export uncertainty and disorder. We do not want German *geld*, nor do we need German sermons. We need good ideas and a clear strategy for the future of EMU 2.0