

The future of macro-economic and monetary integration in Europe

Cezary Wojcik

Prepared for PolSCA Meetings, 10 December 2011

Introduction

- With the sovereign debt crisis spreading across Europe there is no shortage of suggestions on how to save the Eurozone
- The majority of these suggestions have one of the following flaws:
 - Either they address the long-term challenges without dealing with the short-term stabilisation problems (e.g. political integration, fiscal rules, etc)
 - Or they address the short-term stabilisation issues at the cost of the Eurozone's long-term sustainability (e.g. Eurobonds, ECB guarantees for EZ debt, etc)

What can help solve the issue?

- While there is no golden solution, Europe needs something that “hits both birds” at the same time.
- Our solution: the Eurozone needs Treaty provisions on ‘exit rules’ (see more in Fahrholz and Wojcik, 2011).
 - they would achieve both and would also provide added benefits
 - not (!) – we emphasise – because Greece or some other member state should be thrown out, but because such exit rules would strengthen the Eurozone.

Economics of (no) exit rules (1)

- Treaty provisions stipulating that leaving the Eurozone is not possible have been a key source of the imbalances within the Eurozone and of today's difficulties in resolving the crisis
- Such provisions are the legal equivalent of an implicit guarantee that member states will support each other to prevent an exit whatever the circumstances
- This guarantee has given rise to a gigantic moral hazard, both for the markets and member states, and has allowed a small country like Greece to hold the entire Eurozone hostage.

Economics of (no) exit rules (2)

- This guarantee has transcended the Eurozone's framework and is like a bomb with two fuses:
 - **At the economic end:** because of the guarantee, markets have been taking too many risks by treating Greek and German bonds the same way. This has led to a reduction in market discipline, lower interest rates and has provided easy access to capital, which has led countries like Greece to indulge in excessive fiscal spending. The resulting imbalances are now threatening the stability of the Eurozone
 - **At the political end:** the guarantee has shifted the political bargaining power to the profligate countries and given them leeway to pass part of their political and economic adjustment costs onto the rest of the Eurozone. Since the problems in Greece generate a negative externality for the other members, the Eurozone has little choice but to provide a bailout. As a result, there is no credible enforcement mechanism.

What will exit rules do?

- Exit rules will strengthen the Eurozone through four channels:
 1. **Improved external market discipline:** if exiting the Eurozone were openly allowed, the markets would have no choice but to price non-zero probability into their risk assessment and thus better differentiate – not only in crisis times, but also in good times – country risk among Eurozone sovereign bonds
 2. **Strengthened internal macroeconomic discipline:** exit rules would enhance domestic discipline because they would shift internal political economy incentives. They would in essence increase the perceived costs of leaving (now largely hidden) in relation to the short-term political costs of adjustment
 3. **Increased negotiation position and enforcement power of the Eurozone over profligate members:** exit rules would increase the political bargaining power of EZ members vis-à-vis the profligate countries. Their power to enforce fiscal and structural reforms in the profligate countries would increase because the exit rules would become a bargaining chip in their negotiations with these countries,
 4. **Reduced uncertainty:** exit rules would decrease market uncertainty, which would support the political and economic adjustment process. At present, nobody knows what the legal procedure for leaving could be, what the costs would be, and how they would be distributed. Clarifying this would limit the scope for disruptive speculation with all its detrimental effects on the real economy.
- As such, exit rules would decrease (and not increase!) the probability of an exit, or the breakup of the Eurozone.

What will exit rules not do?

- A critique of exit rules may involve the following arguments:
 - **Argument 1:** Discussion on exit rules would open up a Pandora's box at a moment when Europe is in need of stability.
 - Quite the opposite. Opening up such discussions would help stabilise today's mess because Europe's laggards would receive the clear message that the world has changed and there is a limit to the Eurozone's willingness to pay for their negligence. The pressure to deliver would increase.
 - **Argument 2:** Exit rules would run counter to the political ideal of creating an irrevocable monetary union as the basis for a political union
 - Paradoxically, exit rules would decrease (not increase!) the probability of an exit, or the breakup of the Eurozone. Spelling out the exit rules would give the Eurozone what it needs, i.e. enhanced market discipline, stronger enforcement power of the Eurozone, more internal discipline in the profligate countries and reduced market uncertainty
 - **Argument 3:** There are no exit rules in the US monetary union, the blueprint for the Eurozone.
 - It overlooks the nature of the Eurozone: a monetary union among sovereign states, and not a federal state with a common fiscal policy. It is naïve to think that the Eurozone can make substantial progress in political integration sufficiently quickly to avoid another blow somewhere in the near future. Europe is standing on the brink of a precipice between the undesirable now and the desirable future. It does not want to move backwards, but going forward is risky – this is when creativity is needed.

Conclusions

- Eurozone experiences the biggest crisis in its history
- It will overcome it - but it needs solutions that address both the long-term and the short-term challenges
- It is worth considering establishing exit rules – not to throw any member out, but to strengthen the Eurozone
- Exit rules will work bring about: i) improved external market discipline, ii) strengthened internal macroeconomic discipline, iii) increased enforcement power of the Eurozone over profligate members, and iv) reduced uncertainty.
- Specific details is open to debate.

References

- Fahrholz Christian and Cezary Wójcik, (2011), “The Eurozone needs exit rules”, CESifo Working Paper, *forthcoming*
- Fahrholz Christian and Cezary Wójcik, (2011), [“Bail-out! A positive political economics of a Greek type crisis in EMU”](#), CESifo WP 3178

Thank you