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The German Question and the European Question. Monetary Union and European Democracy

INTRODUCTION

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The dramatic clash between creditor and debtor countries in the EU shows that radical reforms are required. In this paper we argue that the EMU is a political project: it is a European public good, which must be provided by a legitimate democratic government. Yet during the crisis, Germany played the role of leading country, and the old dilemma between a German Europe and a European Germany cropped up again. Here we examine two interjurisdictional spillovers caused by asymmetries among the governance and size of the economies in the euro area: the bank-sovereign nexus and the internal deflation trap.

In order to avoid social and economic disequilibria, we propose a European economic model for the euro area based on a long-term balance of payment equilibrium, as an alternative to the German export-led economy model. Current account surpluses and deficits are neither a virtue nor a sin. The euro area should be endowed with a federal budget, enabling the European Commission to employ European savings to spur growth, employment and public and private investments. The new European model must be coherent and compatible with the needs of the other states of the world; the stability of the international economy is also a global public good. Indeed we can look at the European model to draw some principles for reforming the old international economic order set up at Bretton Woods, but now in crisis due to global imbalances and international monetary and financial instability. ■

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EUROPEAN ECONOMIC POLICY AND EUROPEAN DEMOCRACY

The dramatic Eurosummit of 12-13th July 2015 marked a turning point in the history of European integration. After the global financial crisis, the debate on European economic policy – between austerity policies, supported by surplus countries, and expansionary policies, supported by deficit countries – turned into a bailout game[1] between creditors and debtors. In order to win the match, both litigants played the card of the integrity and survival of EMU. The end game showed that the Greek government was bluffing, while the German Finance Minister had a plan for Grexit and the will to carry it out.

The political outcome of the Eurosummit was that Monetary Union, introduced as a crucial step towards a more integrated, prosperous and united Europe, is now viewed as the main cause of conflict and division among its members. "If the euro fails, Europe fails," Angela Merkel has said, and indeed the failure of the European project is now a genuine possibility. Monetary Union is no longer seen as irreversible, and neither is the EU. If Greece, and other overspenders, can be pushed out of the euro area, Monetary Union becomes similar to a system of fixed exchanged rates: the only difference is that it is more difficult and expensive to get out. Grexit was a feasible political choice for the building of *Kerneuropa*, the EMU of strong economies, but with the Grexit proposal the original – and irreversible – political pact for the EMU was broken. According to Jürgen Habermas: "the German Government, including its social democratic faction, has gambled away in one night all the political capital that a better Germany had accumulated in half a century" (*The Guardian*, 16 July 2015).

Pro-European parties and movements have to make a choice. After seven years of austerity and recession, it is clear that the economic policy of the Union is decided by the European Council and, within the Council, by the strongest state, namely Germany (with 29% of the GDP of the euro area) and its allies, the surplus countries. The Franco-German engine of European integration is now nothing but the fig leaf of German leadership and French weakness. So how did this state of affairs come about?

"The Union needs a government. No polity can dispense with that, and the Economic and Monetary Union (EMU) is a polity."

The pro-European forces bear a great deal of responsibility. The EMU is not only a European public good, but also a world public good, insofar as it is essential for the monetary and financial stability of the global economy. During the crisis, the US government, China and Russia urged the German government and the other members of the euro area to spare no effort to save the EMU. Moreover, in a period of rapidly changing international order, with new political powers emerging in every continent, and a dramatic humanitarian, political and military crisis in the Mediterranean region and Eastern Europe, the collapse of the European Union could herald a phase of international disorder similar to that of the last century.

Several political analysts believe that there is a new German question in Europe. Our opinion is that there is a German question, but that all the countries in the euro area and the European Union should share responsibility for the present state of affairs. There is a German question because there is a European question and vice versa. Here we will attempt to show that, due to the revival of nationalism after the end of the Cold War, the German government became the leading player in a complex institutional game based on the dominance of the intergovernmental decision making system, embedded in the Lisbon Treaty, over the so-called Community method, that is the co-legislative decision-making system of the European Parliament and the

1 With regard to the bailout game, see Note 2 in Fiorentini and Montani (2012; 205), which discusses the principle of independence of monetary policy from fiscal policy (established in the Maastricht Treaty). In a centralized federal state, "the power of a federal central government to refuse to bail out a local government is of course reduced if the central government can oblige a central bank to finance its budget" (as happened in Brazil), and therefore the game ends with the bail-out of the local government's debt. But if the central government has to comply with the principle of independence of the central bank (as in the EMU), the conclusion of the note reads: "if the default [of the local government] becomes a realistic possibility, … a new game can be built in which … the cooperative solution" (i.e. an agreement) – becomes possible.

Council, and the executive role of the European Commission.

Germany cannot be held guilty for leading the Union, imposing rules and policies that it deems necessary for the prosperity of the euro area, albeit from the perspective of a single nation. The Union needs a government. No polity can dispense with that, and the Economic and Monetary Union (EMU) is a polity. The real problem is that the European decision-making process can be more or less democratic, and today there is a substantial democratic deficit exploited not only by Germany, but also by anti-European and nationalistic forces. If a national people is obliged to comply with rules it has not approved, sooner or later the rage will explode. When looking for a way out of the present crisis of the European Union, and above all that of the euro area, the focus has to be on two interconnected issues: first, what is the proper economic policy for managing the euro area? Second, what democratic institutions are needed to implement this economic policy?

In the following sections, we shall see how, after unification, Germany became the hegemonic (or rather the semi-hegemonic) power of the Union; we will then discuss the main, widely shared economic doctrine (ordoliberalism) that is deeply rooted in Germany's political parties and public opinion; in the following two sections we will try to show how the euro zone needs a supranational political economy to implement economic and social cohesion among member states and build a new global economic order; lastly, we will outline the main institutional reforms needed for a more democratic Union. ■

GERMANY: A SEMI-HEGEMONIC POWER

In order to understand the present German question, it is useful to exploit the analysis put forward by Hans Kundnani, an acute observer of contemporary German politics. In *The Paradox* of German Power, Kundnani (2014) presents a convincing assessment of modern German history, since national unification in the nineteenth century, and the country's role in the process of European integration after World War II.

The crucial concept at the basis of Kundnani's analysis is drawn from the classic work of Ludwig Dehio, *Germany and World Politics in the Twentieth Century* (1959), though Dehio's more general analysis in *Gleichgewicht oder Hegemonie* (1948) is practically ignored. In his previous book Dehio considered the hegemonic nature of German politics after unification as an aspect of a more general historical process beginning with the creation of the modern system of nation states in Europe. The crucial concept Kundnani takes from Dehio's analysis is that of semi-hegemony. "The unified Germany was too big for a balance of power in Europe and too small for hegemony. The German historian Ludwig Dehio would later aptly identify Germany's problematic position in continental Europe during the *Kaiserreich* as one of 'semi-hegemony': it was not powerful enough to be perceived as a threat by other powers. Thus its size and central location in Europe – the so-called *Mittellage* – made it inherently destabilising. This, in essence, was what became known as the 'German question'" (Kundnani 2014; 8).

Now let's take a look at Kundnani's analysis of the period following the fall of the Berlin Wall and the end of the Cold War. He goes on to analyse various telling developments in recent German economic policy, after the Maastricht Treaty. "At the centre of the increasingly integrated euro area, Germany went, in a decade, from a current account deficit to a huge surplus. Within Germany the turn-around was seen as a triumph." One crucial reform behind this success was Agenda 2010, introduced by Schröder's government. For some years, the reform proved ineffectual: growth remained disappointing and unemployment was rising. Germany was obliged to increase its deficit budget, breaching the rules of the Stability and Growth Pact (SGP). Despite the excessive deficit procedure opened by the European Commission, Germany continued to violate the terms of the SGP. "This fiscal pragmatism – the opposite of the fiscal discipline that Germany would later impose on others in Europe – contributed to Germany's economic success over the following decade" (Kundnani 2014; 71, 74).

The country's economic success was based on many factors, which of course included the traditional strength of German manufacturing. Two of these factors should be recalled. The first is the practice of outsourcing to the Eastern länder and Eastern European countries. "In the second half of the 2000s, German companies began to relocate production to countries such as the Czech Republic, Hungary, Poland and Slovakia – which had acceded to the EU in 2004 – to reduce costs and improve competitiveness… much of central Europe became part of the German supply chain... it also to a large extent aligned the economic interests of these countries with those of Germany and thus increased German power within the EU." This outsourcing had another important effect: it kept wages down, compared with the rising wages in other eurozone countries. "With unemployment rising, German trade unions… agreed to remarkable wage restraint. …This wage restraint, together with the elimination of social security contributions on low-paid jobs that Schröder had introduced, led to a dramatic drop in unit labour costs in Germany at the time when they were increasing elsewhere in the Eurozone." (Kundnani 2014; 74-5; on the same topic, Blyth, 2015). In short, Germany became more competitive in the eurozone due to internal devaluation.

This domestic economic policy had an important external effect: the increasing surplus in German balance of payment, due above all to increasing trade with China and the USA. The new German mercantilism also changed the perception of the German identity. This good internal "housekeeping" had an extraordinary psychological and political impact. "Many argued that others in Europe and the rest of the world should learn from it; thus the idea of 'Modell Deutschland', which went back to the 1970s, re- emerged." (Kundnani 2014; 87).

With regard to German foreign policy, we recall the episode of the election campaign of 2002, when the Bush administration proposed invading Iraq. Gerard Schröder, in an attempt to distance himself from the United States and the "American Way", spoke of a "Deutscher Weg", or German way. Indeed this was essentially followed inside the UN, when France, Russia and Germany opposed the resolution that authorised military intervention in Iraq. We also wish to recall the debate on German "normality", which can be interpreted as the emancipation from the status of semi-sovereign country Germany was obliged to accept after World War II. At the beginning of the 2000s, the bombing of Dresden in February 1945 was openly discussed in the mass media. "For the first time, Germans were able to think of themselves as victims of the Americans. … At the beginning of the twenty-first century, debates about German national identity were expressed through a competition between two specific collective memories: Auschwitz and Dresden." (Kundnani 2014; 62-3).

"The rules established after the World War II for the creation of a peaceful and stable international order are outdated and inadequate; they must be radically overhauled. German hegemony is only possible today within the dysfunctional institutions of the EU."

Kundnani's general conclusion is that Germany can now be viewed as a geo-economic semi-hegemonic power. "With the transformation of Europe since the end of the Cold War, Germany returned to the *Mittellage*[2] in a geographic sense. … Germany has not created stability … but instability in Europe. Germany's rhetoric focuses on stability: it talks about a 'stability union' and is proud of its Stabilitätskultur, or 'stability culture'. But its definition of the concept is extremely narrow: when Germany talks about stability it means price stability and nothing else. In fact, in attempting to export its 'stability culture', Germany has in a broader sense created instability. … Since the euro crisis began, Germany has exported rules but not norms. Many other eurozone countries see the rules as serving Germany's national interests rather than their own. … Germany seems to have returned to the position of semi-hegemony that Ludwig Dehio described – except in geo-economic form." (Kundnani 2014; 107-110).

2 In a remarkable speech delivered in 2011, the former SPD Chancellor Helmut Schmidt supported the point of view, in line with Kundnani's analysis, that: "Seen from central Europe, the history of the continent might well be regarded as a never-ending succession of struggles between the periphery and the centre and vice versa." And with regard to the present financial and debt crisis, Schmidt says: "The European nation states have a long-term strategic interest in their mutual integration. … Should the European Union fail to ensure its capacity to take common action in the decades ahead, … the integration of Germany can hardly continue. The old game between the centre and the periphery might well be resumed. … There is growing concern about German dominance. This time the issue at stake is not a central power that is exceedingly strong in military and political terms, but a centre that is exceedingly powerful in economic terms." (Schmidt 2015).

Kundnani's description of Germany's status in contemporary Europe as a geo-economic semi- hegemonic power is a valid one (Pistone 2015), but we wish to add two observations. The first is that the trend towards the revival of power politics is not just European but global, after the collapse of the Soviet Union and the slow decline of the US as the last "superpower." In the present world system of states the great powers stand up for their national interests in an international environment that is based on a global economy, but beleaguered by regional wars caused directly or indirectly by the conflicting ambitions of the same great powers. The rules established after World War II for the creation of a peaceful and stable international order are outdated and inadequate; they must be radically overhauled. German hegemony is only possible today within the dysfunctional institutions of the EU. Without the EU and the euro area, Germany would be nothing but an old, declining European power, like France and the other European nation states, in a Balkanised Europe. Therefore, the third phase of German semi-hegemony is different from the first two described by Dehio. The old dilemma, a German Europe or a European Germany, can move in a positive direction without occasioning a new tragedy. The second observation is that the status of Germany as a geo-economic power is only transitory, if considered in the long run. The European Union is facing increasing security challenges, at its Eastern borders and in the Mediterranean sea, including migration flows. The demand for European military security is increasing because it is increasingly clear that the US government is not inclined to spend money and risk American lives to defend Europe. If France stubbornly refuses to create a European Defence Community, the way will be open to Germany to build its "normal" army and eventually its nuclear "force de frappe." With its "normal" army, Germany will no longer be just a geo-economic power. ■

THE DOCTRINE OF ORDOLIBERALISM

Ordoliberalism is an economic doctrine that was originally developed by Walter Eucken and the Freiburg school as a reaction to Hitler's regime, during the 1930s and 1940s. After the war, it became the intellectual framework for Erhard's monetary reform and in subsequent years it was reworked to include social rules: so the social market economy (in brief, here we will only address ordoliberalism, the theoretical core) became the main ideological doctrine of centre-right and centre left political parties in Germany (for a survey, Vanberg 2011; Dullien and Guérot 2012).

Ordoliberalism should not be confused with neo-liberalism of the Austrian school, though there are some overlapping views, especially on the relationship between the micro- and macro-economy. The core of ordoliberalism is the idea that the state should establish and promote market competition, in order to avoid the creation of trusts, monopolies and strong economic pressure groups challenging the national government. During the Nazi regime the old federal, decentralized political system was completely transformed, without changing the constitution, into a highly centralized economic system. Dirigisme replaced the market economy. Ordoliberals believe there should be a clear constitutional division of powers, especially between economic and political actors: a free market economy can only thrive within a strong state, contrary to what modern neoliberal economists think.

A crucial aspect of ordoliberalism is its rejection of macroeconomic policies to manage effective demand, as supported by Keynesian economists (*The Economist* 2015). If the social market economy is well regulated, with effective competition rules, with a central bank independent from the government and capable of fulfilling the goal of price stability, with a system of social relations complying with the rule that wages increase *pari passu* with productivity, the social and political goal of full employment can easily be reached. This approach is therefore similar to that of the modern neo-classical school of supply-side economics. In normal times, but also after an economic downturn, the real problem for ordoliberals is to increase internal and external competitiveness. If the national economy is more competitive than the other economies in the international market, exportations will increase and so will internal output and employment. It is therefore essential for the government to do its "housekeeping" effectively. In this way, ordoliberalism is also a doctrine for a well managed international economic order: if every national country provides a proper social market economy, the stability of the international order is assured. In the last resort, the national management of home aggregate demand, especially with deficit spending policies, leads to inflation, the inefficient allocation of resources and international instability: different rates of national inflation sooner or later cause devaluation or re-evaluation of national exchange rates. Ordoliberalism is the doctrine of national and international economic stability, even without a monetary union.

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Now, let's take a look at cases in which the doctrine of ordoliberalism has had a concrete impact on the construction and development of the EMU.

Firstly, in the Maastricht Treaty, five convergence criteria were established to be certain that only countries which had their "house in order" were admitted to the Monetary Union: a low inflation rate; a low interest rate; no devaluation of the national currency at least for two years; a budget deficit of no more than 3% of the GDP and a public debt of no more than 60% of GDP. The last two financial criteria later became the basis of the Stability and Growth Pact (SGP).

Secondly, in the Maastricht Treaty (now the Lisbon Treaty) the principle of the independence of the ECB from national governments and European institutions is clearly stated. This entails the relative independence of monetary policy, whose main goal is price stability, from national and European budgetary policies: the no-bailout clause forbids the monetary financing of national budgets and the European budget. This principle was also viewed as a tacit agreement to prevent the EMU from becoming a "transfer union."

In third place, after the Greek crisis in 2010 and the spread of the sovereign debt crisis to other EMU countries, it was necessary to create some emergency funds – the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) – to provide financial aid to governments that were insolvent or at risk of insolvency. But strict conditionality was applied to this aid, decided on the basis of intergovernmental rules. The German government asked for a more general framework to reinforce the SGP, whose rules had been breached too frequently. After the German grand coalition approved a constitutional amendment, called *Schuldenbremse*, in 2009, basically a debt cap for the federal budget of 0.35% of GDP, a similar rule was proposed for all EMU member states. The Treaty on Stability, Coordination and Governance (TSCG) was signed in 2012 and entered into force in 2013, when it was ratified by 25 states. In fact, the so- called Fiscal Compact obliges countries to include the balanced budget rule in their constitutions or laws (the limit of structural deficit is 0.5% of GDP).

In fourth place, when it was necessary to impose conditionality on Greece, the German government asked the IMF to join the European Commission and the ECB (the Troika). This decision reveals the ordoliberal conception of the EMU: it is nothing but a gold standard, the system of fixed rates of exchange that arose spontaneously in the nineteenth century. The only difference is that the euro is a fiat money, because in the twenty-first century gold is no longer used for trade and financial transactions. According to ordoliberals the EMU is a monetary agreement for the stability of prices and exchange rates, and nothing more: the no-bailout clause excludes financial and political commitments among the member states of the EMU. A federal system is different. When, in 2010, California defaulted, the US federal government did not ask for aid from the IMF. Indeed, many poor countries, members of the IMF, rightly protested against Europe's improper use of the IMF.

To conclude, the crisis of the euro area reveals the ideological limit of ordoliberalism, an economic doctrine that came about as an alternative to Nazi dirigisme. It certainly played an important, positive role during postwar reconstruction and the economic miracle, but its internationalist conception is a serious limit, as it is in sharp opposition with the founding principle of European integration: supranationalism. In the Schuman declaration, the European project of the European Coal and Steel Community (ECSC) was presented as a federation in progress. Ordoliberalism did not clash with the process of European integration until the creation of the euro. After Maastricht, the Bundesbank, which is considered the temple where the true principles of the doctrine are preserved, strongly opposed any attempt to change the rules agreed in the Treaty or make them more flexible. But after the EMU crisis, the demand for change could not be ignored. This is the view of the President of the Bundesbank, Jens Weidmann: "it was a long-held belief, above all in Germany, that in the long run monetary union would, out of necessity as it were, culminate in political union. Addressing the Bundestag in November 1991, Helmut Kohl remarked that 'the idea of sustaining economic and monetary union over time without political union is a fallacy'. I believe, however, that monetary union can also function without political union. The Maastricht framework which was adjusted in the light of the crisis, offers a sensible foundation for this in principle." (Weidmann, 2015a). This view seems to be fully shared by the Finance Minister Wolfang Schäuble, who, in view of the Eurosummit of July 12th, circulated a plan for Grexit, convinced that *Kerneuropa* can be reinforced by pushing out insolvent members: no fiscal union or political union is required by a group of states which promise to keep their houses in order. For the German people, it is time to choose between an international or supranational EMU. ■

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A SUPRANATIONAL ECONOMIC POLICY FOR THE EMU

The crisis was characterised by two opposing economic policies. The first was the austerity policy supported by the German government and the surplus countries, the second was the policy for more flexibility of the SGP's fiscal constraints. Behind these policies it is easy to see the ordoliberal and the Keynesian economic theories. The priority for the supporters of austerity policies was to keep national public budgets in order, i.e. in balance or close to balance. The priority for Keynesian economists and the national governments in favour of flexibility was to spur growth and decrease unemployment with more national public spending, i.e. more deficit and debt. Both economic policies share a certain notion of good international order: if every country keeps its house in order, the international economy will thrive. Unfortunately this simplistic point of view is unfounded. What will happen if a country with its house in order causes negative spillover effects on other countries, for instance with beggar-thy-neighbour policies? And if a country is damaged by an external foreign policy, how will it respond: economic retaliation, diplomatic complaint or war?

Here we will attempt to show that it is possible, and profitable, for the European Union to strike a compromise between ordoliberal and Keynesian economics, and the governments supporting these views: a supranational economic policy – with the institutional means required to implement it – can be established. The ordoliberals have to accept that Europe's aggregate demand must be managed to ensure growth, full employment and social cohesion in the European economy. Keynesian economists must accept that in an economic and monetary union hard constraints of national budget are necessary, because excessive deficit and debts can cause damage – such as too much inflation – to the other member countries. The history of European integration shows that supranational institutions – when a degree of national power is surrendered to the EU – can provide European public goods. For instance, the single European market is a supranational public good which can only work well if the European Commission and the European Court of Justice can impose rules to prevent national governments providing state aid to ailing companies. Here we discuss two crucial cases of interjurisdictional spillover which emerged during the crisis: the bank-sovereign nexus, which led to the re-nationalisation of the banking and financial system, and the internal deflation trap, which caused the deflation of European aggregate demand and high unemployment rates. A detailed description of these two spillovers is furnished in the Appendix.

Before discussing these spillovers it is necessary to say something about the trade-off between the spending power of the federal government, that is the size of the federal budget, and the rigidity of the "stupid rules" of the SGP, established without taking into account that emergencies, like the global financial crisis, can happen and have to be addressed using exceptional monetary and fiscal means.[3] In normal times, according to Kenneth Wheare, fiscal federalism is based on the principle that "general and regional governments must each have under its own independent control financial resources sufficient to perform its exclusive functions." (Wheare 1967; 93). However it is very difficult to implement this principle because of the overlapping functions among local, regional and federal governments and the spillover effects among different jurisdictions. Therefore, to correct the inevitable vertical and horizontal imbalances arising in a multilevel system of government, the federal government must have spending power.[4] To clarify the kind ofspending power we are talking about, taking account of the fact that the present budget of the EU, which is 1% of the EU GDP, we believe it should be increased to 2-2.5% or little more (without defence and foreign policy expenditure) as proposed by the MacDougall Report of 1977. This modest budget increase is now viewed as taboo, after the thick smoke screen raised during the sovereign debt crisis by "no tranfer union" propaganda. The "no transfer union" dogma is groundless, because every public budget comprises some financial transfer and the EU budget, as it is now, already comprises some transfer financial effects. The aim of the structural funds created with the Delors Package I (1988) and the Delors Package II (1992) was to transfer financial aid from rich regions to poor regions and from rich member states to poor member states. Therefore when addressing the EU budget we must remember how much fiscal transfers are necessary to "promote economic, social and territorial cohesion, and solidarity among its member states," as is stated in Article 3 of the Lisbon Treaty. Of course, we are aware that the degree of solidarity among citizens belonging to different nations is lower than the degree of solidarity among citizens of the same nation; nevertheless no political community can survive without sharing common values and common public goods.

"The history of European integration shows that supranational institutions - when a degree of national power is surrendered to the EU - can provide European public goods. "

Now let's examine the two spillovers, bearing in mind that our general aim is the supranational economic policy required to keep the balance of payments of the euro area in equilibrium, or with a limited surplus or deficit in the short run. This goal means that the balance of payments of the member states should not be viewed as a goal of European economic policy, just as it is not a goal for the federal government in the US to keep the BoP of its 50 member states in equilibrium, or for the German federal government to monitor the current account deficits or surpluses of the Länder. Of course, the European Commission can consider the deficits and surpluses of the member states as one of the indexes of the health of a certain economy, such as the per capita GDP, the rate of inflation, the Unit Labour Cost (ULC), the male and female employment rate, debt/GDP, etc.

The re-nationalization of the banking and financial system began with the Greek crisis, when the German government declared that the no-bailout clause of the Treaty had to be respected and that Greece could leave the EMU. The first decade of the EMU experiment showed a spontaneous

3 The present rules established by the SGP do not allow the EU to respond appropriately to extraordinary crises. In an emergency the dividing line between monetary policy and fiscal policy is blurred. So ordoliberal and Keynesian economists propose different policies. Considering the independence of the ECB and the relationship between monetary and fiscal policy in the EMU, Otmar Issing (2008, 236) observes: "The area where the currency and politics rub up against each other is that of public finances. Control over public finances goes to the heart of western democracy. If this were to be transferred from the national to the European level, one would de facto have largely attained political union." Of course, since Issing supports the strict independence of monetary policy from fiscal policy, also when a dramatic crisis hits, no "transfer union" is possible and Grexit can be envisaged. Adair Turner makes a similar observation concerning a permanent quantitative easing policy during a severe crisis, but draws different conclusions: "If that does occur, some or all QE will turn out post facto to have entailed money finance of fiscal deficits." And concerning the relationship between monetary and fiscal policy in the EMU Turner remarks: "The attainment of optimal policy is severely constrained by structural deficiencies within the Eurozone project. The required first steps in resolving these deficiencies, difficult enough in themselves, entail fiscal federalism, with some small but still significant revenue/expenditures at federal level and the creation of some variant of Eurobonds." (Turner 2013; 37-39). In the EMU with a federal budget the crucial question is: For the integrity of the EMU are the European convergence policies effective enough?

4 In a popular textbook of fiscal federalism spending power is considered: "an indispensable policy instrument for enabling the federal government to pursue its national efficiency and equity objectives in circumstances in which state expenditure programs have important national consequences" (Boadway and Shah, 2009, 78). To apply this to the EU, substitute "national" with "European" in this statement.

convergence of interest rates in all countries and a flow of capital from countries with high saving rates to countries in need of investment. After the beginning of the Greek crisis, for the global financial market it was crystal clear that the overly indebted governments in the EMU had to solve the problem with their own forces. Capital started to flow back from the so-called PIIGS to various safe havens, above all Germany. The Credit Default Swap (CDS) on sovereign bonds soared and, since national bonds were the main component of bank reserves, the sovereign bond crisis was followed by a serious crisis in the banking system in states at risk of insolvency.

We will not examine all the European reforms, such as the ESM, implemented to stop the crisis and help states at risk of insolvency, but only the banking reforms, above all the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). According to Mario Draghi, the President of the ECB, the dangerous fragmentation of the European financial system was caused by incomplete integration (Draghi 2014a). While the interbank market was fully integrated, retail banking remained fragmented. Therefore the core aim of the reform was to get rid of the "infamous bank-sovereign nexus." With the new banking union it is now possible: a) to reduce so-called related lending, namely the power of local banks "to increase lending towards favoured domestic sectors such as real estate," as happened in Spain and Ireland; b) to lessen the risk of bad composition of bank reserves, with too many foreign short-term and debt-based liabilities, which "could quickly dry up at the first sign of distress," and lastly c) to reduce the cost to national fiscal authorities of shoring up banks' balance sheets when crisis hits, thanks to the creation of the single resolution fund. In short, the bank-sovereign nexus can be overcome, providing that bank failures are borne first and foremost by the private sector; bail-ins must precede bail-outs so the costs of failure are more evenly spread among all the euro area countries.

"Banking union is certainly a step in the right direction, but it is not enough for the complete financial integration of the euro area. A better capital market integration is also needed."

Banking union is certainly a step in the right direction, but it is not enough for the complete financial integration of the euro area. As Draghi acknowledges, better capital market integration is also required. Indeed the European Commission has already proposed a first draft for a Capital Markets Union (EC, 2015), but this proposal mainly concerns sources of funding for companies; it is based on a microeconomic approach. From a macroeconomic point of view we can observe that the euro area needs a public bonds market based on federal bonds issued by the European Commission (or the future European government).[5]

Banking union is certainly a step in the right direction, but it is not enough for the complete financial integration of the euro area. As Draghi acknowledges, better capital market integration is also required. Indeed the European Commission has already proposed a first draft for a Capital Markets Union (EC, 2015), but this proposal mainly concerns sources of funding for companies; it is based on a microeconomic approach. From a macroeconomic point of view we can observe that the euro area needs a public bonds market based on federal bonds issued by the European Commission (or the future European government).5

European federal bonds, similar to US Treasury bonds, are the real tools needed to get rid of the "infamous bank-sovereign nexus." They can circulate in all the euro area countries without the risk of a sudden change in their value in the event of a national government experiencing financial distress; they are perfectly transferable assets, which exist in every well-managed monetary union (Montani, 2013). There is an objection concerning the issue of federal bonds. Some economist could observe that due to the small size of the European budget, European federal bonds would be insufficient for the entire European banking system. Indeed the proposal to mutualise a share of national debts, along the lines suggested by Delpa and von Weizsäcker (2010) – i.e. blue bonds and red bonds – should be reconsidered (for instance, for 20-30% of GDP). Federal bonds are European public goods, a crucial step towards political union, because with European Treasury Bonds the euro area can compete with the dollar area capital market on a level playing field.

5 The Juncker Plan, which had problems financing the European Fund for Strategic Investments from the European budget, could also be financed by European Federal Bonds

Now let's consider the second jurisdictional spillover, the internal devaluation trap. This trap is caused by the disproportion among the size of the euro area countries' economies and their different national economic policies. Martin Wolf rightly observes that the logic of internal and external balances can be applied to the euro area: in a world economy the sum of surplus and deficits is zero. "Once we do that, it becomes obvious that the biggest challenge has been created not by excess demand on the periphery, but chronically deficient demand at the core. The problem, in brief, is Germany and – to a far lesser degree, because they are so much smaller – other creditor countries inside the euro area" (Wolf 2014; 177). As we have already seen in the previous section, after unification Germany recovered thanks to a series of reforms introduced by the Schröder government. These reforms greatly increased the competitiveness of the German economy in the world market. But they caused also external diseconomies in the other euro area member states, whose industrial and labour market systems were not export-led economies. As Sebastian Dullien remarks: "German success, in terms of its large current account surplus, low unemployment rate and acceptable economic growth, stems from a combination of nominal wage restraints, supported by labour market reforms which have … put downward pressure on wages, and severe spending restraints on both public investment as well as on research and development and education. On the whole, this cannot serve as a blueprint for Europe. Some elements of the German model have negative externalities on its partners in Europe." (Dullien 2014; 157; on the same topic, Posen, 2013).

"If the Modell-Deutschland is not a good one for the euro area, what is the Modell Europa?"

Indeed, during the crisis, German pressure on deficit countries to comply with the Fiscal Compact rules obliged the PIIGS countries to increase competitiveness by means of deflationary internal policies: cutting private and public expenses, increasing unemployment and moderating wage increases. The outcome was the fall of euro area's aggregate demand, a lose-lose policy. Martin Wolf observes: "The implications of the attempt to force the eurozone to mimic the path to adjustment taken by Germany in the 2000s are profound. For the eurozone it makes prolonged stagnation, particularly in the crisis-hit countries, probable. Moreover, … the shift of the eurozone into surplus is a contractionary shock for the world economy. The eurozone is not a small, open economy, but the second-largest in the world. It is too big and the external competitiveness of its weaker countries too frail to make big shifts in the external accounts a workable post-crisis strategy for economic adjustment and growth." (Wolf 2014; 303).

If the *Modell Deutschland* is not a good one for the euro area, what is the *Modell Europa*? ■

THE EUROPEAN MODEL AND THE NEW WORLD ECONOMIC ORDER

In order to pinpoint the main features of the European model we should bear in mind that the European Union is a federation in progress. However it cannot draw too many lessons from existing federations. The reason is that all existing federal states are also nation states, while the EU is a union of national peoples (or nation states). For instance, the USA is certainly a very useful model, but it must be noted that the USA built its banking union in the late nineteenth century, before the creation of the Federal Reserve System, and that the US welfare state was built during the New Deal mainly on a federal level, while the European welfare systems are national and there are no serious reasons to merge them into a single European welfare system. These differences also explain why the American Federation has not faced the two spillovers we have just discussed for the euro area. So, our task is to build a supranational federal Union, which is based on shared political values, fundamental rights and common policies, but which cannot become a European nation: we must admit that the degree of fiscal solidarity among

European citizens is lower than the degree of solidarity among citizens and local communities in the same nation.

Our proposals for the European model are merely a contribution to an ongoing debate, because we are aware that only the European institutions, including the European parties, can define the general framework for wide-ranging reform. We focus on *The Report of the Five Presidents* (Juncker, 2015), in order to underline the need for the European Commission to play a political role, managing a greater EU budget. This is the first critique to the Report. In other words, the European Commission needs to count on increased "spending power" to implement effective policies for convergence, growth and more jobs for EU citizens. Moreover, and this is the second critique, we agree that: "solving the euro crisis demands not only structural reforms to the EU system, but also new systems of global governance" (Patomäki, 2013). This is the main flaw in The Report of the Five Presidents. We cannot forget that the EU is not an isolated economy in an unregulated global market. All policies and reforms under discussion are interdependent. Consider the proposal for the Transatlantic Trade and Investment Partnership (TTIP): how can we discuss the abolition of trade and non-trade barriers between the USA and the EU without considering that the exchange rate between the dollar and the euro can fluctuate by 15% or more? If China changes the value of the yuan or its rate of growth slows down, the European economy is affected. A new global financial crisis remains a possibility. The European economy is only one piece, albeit undoubtedly an important one, in a much wider game. The EU vessel needs a captain to sail it in uncharted waters. We therefore need to overcome the taboo surrounding the political role of the European Commission: it needs spending power to govern the EU economy and not only to enforce rules. The Commission must use its spending power as a carrot and a stick, as all other federal governments do, especially during a storm.

"The European economy is only one piece, albeit undoubtedly an important one, in a much wider game. We therefore need to overcome the taboo surrounding the political role of the European Commission: it needs spending power to govern the EU economy and not only to enforce rules."

Let's take internal European reforms. *The Report of the Five Presidents* correctly underlines the four pillars of the Euro Plus Pact, namely the creation of a euro area system of Competitiveness Authorities, the reinforced implementation of the Macroeconomic Imbalance Procedure, a greater focus on employment and social performance, and a stronger coordination of economic policies within a revamped European Semester. All of these reforms should be implemented in line with the Community method. One thing we would add to this list of reforms, to avoid the negative spillovers caused by internal devaluations, is that the correction of macroeconomic imbalances should be symmetrical, that is, if a current account deficit of more than 4% of GDP is deemed excessive, a surplus of more than 4% of GDP should also be considered excessive (and not 6% as currently stands). Moreover, the euro area budget has to be big enough to finance: a) a shock absorption mechanism for excessive unemployment during a crisis; b) a bigger European Fund for Strategic Investment, which is crucial for growth and employment; c) an increased fund for scientific research, education and innovation, like Horizon 2020; and lastly, d) more structural funds, to provide for the European Social Fund (ESF), the European Regional Development Fund (ERDF), the Cohesion Fund (CF), the Youth Employment Initiative and aid for the deprived. All of these funds are crucial for fostering employment, new jobs and new investments, especially if facing environmental and local administration problems. The national welfare systems need a European roof (for more details see Fiorentini and Montani 2014).

Our second observation regards the role of the EU in the world economy. Structural reforms are not only crucial for member states of the Union, but also for building a new international economic order, which is a crucial global public good. The old order created after the Second World War is crumbling. The EU needs an international strategy. The first step is to establish – in agreement with the other countries – the main principles on which the new international order must be built. We propose four principles: 1. global imbalances should be avoided, which means that all countries must agree on a ceiling to cap excessive current account deficits or surpluses; in the long run the balance of payments of every country must be in equilibrium; 2. the stability of the international monetary system requires that exchange rates – at least among the main international reserve currencies – do not fluctuate freely, but be managed in cooperation among all the countries involved; c) national debts should not exceed a prudential ceiling, and lastly d) while these principles are required to keep the house of every economy in order, they are not enough to face the most urgent global challenges - therefore a limited UN budget should be agreed on to fight global poverty and avoid the risk of an irreversible environmental crisis: sustainable development is a global public good. Subsequently a new Bretton Woods could be negotiated. Of course we are very far from this goal. However the external policy for a new global order should be one of the main tasks for a bold EU. If a group of world leading countries agreed to discuss the general framework for a new global order it would become possible to start building the institutions required to fix it (for more details, see Fiorentini and Montani, 2012). ■

EUROPEAN DEMOCRACY AND NATIONAL DEMOCRACY

The Greek crisis showed how unsustainable and anti-democratic the present decision-making system of the EU is. The European Council acts as the real government of the Union, but it is accountable neither to national parliaments nor to the European Parliament, and nobody has the power to dismiss this phoney European government. The outcome of the intergovernmental system was that the decision on European policy turned into direct clashes among national governments. These clashes are perceived by citizens as the revival of national rivalries. Moreover, European disunion gives rise to domestic political dysfunctions because citizens view EU rules as intolerable fetters on their national democratic processes and, as an alternative, support populist and nationalist parties. An institutional reform of the EU decision-making system is urgently required. In order to outline this reform, we can recall three governance flaws caused by gaps in the Lisbon Treaty, which allowed the European Council to take inaccurate decisions.

"The European Council acts as the real government of the Union, but it is accountable neither to national parliaments nor to the European Parliament, and nobody has the power to dismiss this phoney European government."

The first governance flaw concerns the prevalence of the German point of view on the causes and the cure of the financial crisis, the so-called austerity. The programme imposed on Greece is a good example. Before 2010, the Greek government was responsible for mismanagement and fraud. But the decision taken by the Council imposed an overly harsh programme on the Greek people. According to a *Study* for the European Parliament (2014), "reality proved the initial programme's assumptions largely wrong." When financial assistance was first requested in May 2010 Greece started from a very high deficit of above 15% and a very high debt, but "the situation took a turn for the worse in 2011 and, against the background of heightened market concern, domestic demand and GDP, growth plummeted, investments collapsed, and exports stagnated." The Troika overestimated the effectiveness of Greece's government machinery. Excessive austerity was imposed, and while public deficit did indeed come down from 15% of GDP to around 4% by the end of 2013, "a less rapid fiscal adjustment might have helped to preserve some of the productive capacity that, in the course of the adjustment, was destroyed." The error of the Council and the Troika was to think that a politically corrupt system of government and an inefficient administration could be changed in the space of a few years. Greece – and the same could be said for many other states and regional governments in the EU – probably requires assistance for some decades, but not from a Troika.

The second governance flaw concerns the decision to create the

Troika, with representatives of the IMF, the ECB and the European Commission, to supervise the adjustment programmes. We have already criticized the inclusion of the IMF, an international institution mainly designed to help poor countries. However the inclusion of the ECB as a "creditor" was also misplaced. The institutional goal of the ECB is price stability, and also financial and banking stability, after the creation of the banking union. Including the ECB among the "creditors" undermined the dividing line between monetary and fiscal functions agreed at Maastricht. Indeed during the Greek crisis the ECB ran the risk of getting involved in political issues: some asked it not to give liquidity to Greek banks, in order to force Greece out of the euro area, while others wanted the ECB to provide the Greek banking system with all the liquidity necessary for the normal functioning of the economy (Wyplosz, 2015). Indeed the creation of the Troika looks like a sleight of hand performed to avoid admitting that the European Commission is the only legitimate executive – or government – of the EU: its President was appointed by a majority of the European Parliament after the European Election of 2014. The European Council and the German government probably feared that the Commission would acquire an overly political role in the public eye.

The third governance flaw concerns the distinction between the political and economic concepts of the Monetary Union. According to Mario Draghi, the monetary union is "by nature political". The reason is that "fiat money is a political construct, and monetary union could not operate without adequate political structures" (Draghi 2014b). The crisis showed that the union is an incomplete construction. One of the political pillars of the EMU was its irreversibility: the procedure for a member country to leave the euro area is not contemplated. In effect this political interpretation was not openly discussed in the Eurosummit, but a plan circulated for a temporary and "voluntary" Grexit. The rationale of this proposal was that since a core group of countries (*Kerneuropa*) was able to comply with the rules agreed, then peripheral countries, which were unable to comply had to accept a different status. From this perspective the EMU is a system of fixed rates of exchange, and the pact concerns the rates of exchange and the rules necessary to preserve them, not political and social cohesion among its members.

"If they wish to build a more perfect union they should follow the path outlined in the Schuman declaration, and build the supranational institutions needed to complete the EMU, above all a federal and a democratic European government."

On the contrary, if we adopt the political concept of the Monetary Union, we must first recall that Greece plays a crucial geopolitical role (in relations with Russia, Turkey and the Middle East) and that Greek citizens are also European citizens, therefore they have the constitutional right to be a member of the EMU. Of course Greece has to respect the rules agreed for the functioning of the Monetary Union, but the debate about the rules and the economic policy degenerated into a clash between creditors and debtors. This means that some rules are missing, or wrong. Indeed, the Treaty says nothing about the failure of the government of a euro area country. Jens Weidman (2015b) rightly says that monetary union must be based on the "principle of individual national responsibility," which ultimately means "that governments, too, must be allowed to fail financially." However the two principles of national responsibility and political financial default, mean different things in a political and economic union. For Weidmann monetary union can function without political union, and therefore there can be no flexibility in the GSP and the Fiscal Compact. On the contrary, if supranational European institutions are envisaged, such as the federal budget and the federal government, a different EMU can be conceived: when a crisis hits supranational institutions can provide the required rebalancing (or flexibility) among countries with different capacities to respond to challenges. There is a trade-off between federal institutions and national constraints. A political concept of the monetary union includes various rules and institutions designed to implement a minimum of solidarity among member states. The federal government must have proper spending power to offset the negative effects of the two spillovers we have just discussed, or external shocks. National fiscal responsibility is the other face of European democratic responsibility.

The goal of this paper was only to clarify the main problems up for discussion and to point to ways to overcome the difficulties and the errors caused by the intergovernmental system. In our view Germany, France and all the member states of the euro area have a common interest in abandoning a decision-making system that causes national rivalries among them. If they wish to build a more perfect union they should follow the path outlined in the Schuman declaration, and build the supranational institutions needed to complete the EMU, above all a federal budget and a democratic European government. The European Union is a union of democratic states. The crisis showed that national democracy was humiliated because of the European democratic deficit.

"The silence of the European Parliament is the hidden side od the European democratic deficit [..]. The so-called European parties are the missing link between national democracy and European democracy."

To describe the difficult task facing European leaders we can examine historical evidence from the distant past. Michael Mann analysed the birth of the ancient states on the basis of four powers: ideology, economic power, military power and political power. Ancient Mesopotamia offers the first clear example of what can happen among different city-states. "Sumerian culture was not unitary … it was federal", says Mann. "Each city-state had its own tutelary deity. Whatever the conflicts between the cities, they were regulated, both ideologically and perhaps in diplomatic practice, by the pantheon." The leaders of the city- states: "were exercising coercive powers over the inner periphery … This was the first stage of civilization – two-level, segmental, semicaged. … a multistate civilization emerged" (Mann 2012, 91-93). We do not wish to push the comparison too far. It suffices to observe that the old European ideology, which was the basis for the process of European integration after the Second World War, has now changed the nature of the European Union. The Greek crisis showed that dismantling the EMU would have too high a cost, not only in economic terms, for both weak and strong member states. The EMU, as it is, is now an incomprehensible cage, which merely serves as the basis for the coercive power of the European Council. For Mesopotamia's city-states the crisis was solved with the creation of kingdoms and empires.[6] The European Union cannot become an empire ruled by a hegemonic state. The only legitimate power for a Union of democracies is a democratic European government.

We acknowledge that the path towards a democratic European government is a difficult one, because there are many questions on the table, such as the UK demand for less integration, large-scale immigration and the challenges of foreign policy. But there is a clear road map, which was indicated in the Schuman declaration and the Draft Treaty of the European Union, approved by the European Parliament in 1984, and imprudently rejected by national governments. The central idea is that the European Commission should become the real European government accountable to a double-chamber Parliament: the European Parliament, the chamber of citizens, and the Council of Ministers, the chamber of member states. Of course, the Council of Ministers should abandon the veto right and accept democratic voting rules.

Finally, we wish to underline that the responsibility for the dramatic crisis of the EU and the over- long recession falls not only on the national governments, but also on the European parties. The European Parliament was directly elected in 1979, but to date no European parties have been formed: MEPs are merely members of national parties who sit in the European Parliament. The European parties do not organize European democratic congresses; they do not have European activists; they do not democratically elect their leaders; they do not mobilize citizens on occasion of political events and emergencies. During the crisis the European Parliament was incapable of indicating a way to reform the limping Union. The silence of the European Parliament is the hidden side of the European democratic deficit, and it is no wonder that populist and nationalist parties are exploiting citizens' anger against traditional parties. The so-called European parties are the missing link between national democracy and European democracy. ■

6 According to Mann: "For something like seven hundred years, the dominant form of Sumerian civilization was a multistate structure of at least twelve principal city-states. Thus there was no swift move toward larger, more hierarchical organizations of power. In the latter half of that period, however, the city-state began to change its internal form as kingship became dominant. Then, from about 2300 B.C., the autonomy of the city-state began to weaken as regional confederations of cities emerged. Finally these were conquered by the first extensive 'empire' of recorded history, that of Sargon of Akkad" (Mann 2012; 130-1).

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ABOUT THE UEF

The Union of European Federalists (UEF) is a pan-European, non-governmental political organisation dedicated to the promotion of European political unity. Throughout the past 70 years it has been a leading voice in the promotion of European unity and an early campaigner for key milestones in the development of the European Communities and the European Union.

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