

THE EURO CRISIS—WHAT COULD GO WRONG?

The European Union is facing a crisis because of the loss of confidence in the debts issued by several member states. This is related directly to the problems and activities of Europe's banks.

On 9 December in Brussels, the Heads of Government of the 27 EU member states meet, yet again, to come forward with a solution to the escalating loss of confidence in the debts owed by European banks and governments. Each time leaders meet, and come forward with proposals that, within days, prove to be inadequate, further confidence is lost both in the leaders themselves, and in the European Union, as a functioning and competent political authority capable of managing the affairs of its peoples.

This is corrosive. It undermines political solidarity within and between Europeans, and it encourages reversion to 1930s style nationalism, and to general anti politician sentiment, which could eventually erode the tolerance that is essential to democracy itself.

There is a limit to the number of failed government bond auctions we can endure. Many further such bond auctions are due in January and February. In February there will be a General Election in Greece, and the campaign in that election will be critically influenced by the perceived effectiveness of present EU arrangements and the steps Greeks are having to take to comply with these arrangements. If there is to be a good result in that election, the EU needs to show electors that it is in control of the situation.

THE ECB CAN ACT NOW, AND SHOULD DO SO

The European Central Bank needs to take note of the situation. It has a mandate under EU Treaties to maintain price stability, defined as around 2% inflation. There is a growing risk that the problem Europe will face next year will be deflation, not inflation.

If industrial orders and consumer confidence continue to decline, prices and incomes will start to fall, and the situation of those in debt will worsen further because, even if they pay all interest, the real value of their debts will increase as a consequence of the fall in prices and incomes relative to the unchanged level of their debts.

If these circumstances are likely to arise, the ECB has a duty, in the interests of price stability, and in full accord with its Treaty mandate, to initiate quantitative easing to prevent it. An immediate statement to that effect from the ECB would go a long way towards resolving the short term crisis.

CONSEQUENCES OF A BREAKUP OF EURO

Failure to act could lead to a break up of the euro. This could be devastating, because a lot of the debts owed by Europeans are owed in euro to other Europeans. With the euro gone, the uncertainty about who owed how much, in what currency, to whom could lead to endless legal dispute.

Governments trying to establish new national currencies could face huge problems stopping outflows, which could lead to limitations on bank withdrawals, reintroduction of exchange controls, and tariff walls against their exports by other countries in the EU aimed at countering competitive devaluations of one new currency against another.

The legal order on which the EU is based could break down. We should not forget how inherently fragile that legal order has always been. If one country refuses to implement a judgement of the European Court of Justice in an important matter, and gets away with it, the EU has no meaning anymore because the EU has no police force to enforce its rules. Everything is based on consent.

Against this background, one must ask oneself if further EU Treaty change could be part of the answer. Treaty change could take, at the very least, a year to effect. But we do not have that much time. So the best we can hope for is a political commitment by Governments to seek consent to a Treaty change from their parliaments or peoples.

SPEECHES OF CHANCELLOR MERKEL AND PRESIDENT SARKOZY

There has been agreement that a proposal to improve the governance of the euro zone would be presented by the President of the European Council, Hermann Van Rompuy to the EU Summit on 9 December. In advance of this, the leaders of the two biggest euro area states have set out their requirements.

In her speech today, Chancellor Merkel has called for Treaty changes that would make sanctions on states who breach debt and deficit limits automatic and capable of being enforced directly through the European Court of Justice. It would take the issue out of politics and make it a legal one. This would require a change in the Treaties.

President Sarkozy, on the other hand, said yesterday that European integration must be pursued, and the problem has to be solved, inter governmentally. This is because he believes that only elected heads of national governments have the required political legitimacy to make the necessary decisions.

These two positions are quite far apart, and there are difficulties with both of them.

The difficulty with Chancellor Merkel's approach is that it will involve the European Court of Justice in making economic judgements.

In the case of a disputes, is the Court really qualified to judge whether a deficit is excessive by reference to the point at which a country is at in its economic cycle? Can it adjudicate on whether estimates of future revenue are valid or not?

Even economists have difficulty with these issues. So the framing of a Treaty change in this area will be challenging.

President Sarkozy's preference for inter governmentality will bring economic judgements into the realm of power politics, the sort of power politics that prevented any sanctions being imposed on France and Germany when they became the first to breach the original Stability and Growth Pact. His approach would diminish the role of the European Commission.

Both the Chancellor and the President are paying too little attention to what has been already agreed in the "six pack" regulations. These, which require no Treaty change, will already make it more likely that a state, with an excessive deficit, will be fined, because a qualified majority (66%) would have to be found to agree NOT to impose a fine.

Neither the Chancellor nor the President pay enough attention to the huge failure of EU wide banking supervision that allowed all this foolish cross border lending to take place within the single currency area. Neither of them addressed the lack of implementation, from the very outset of the euro, of the ECB's responsibilities in the Treaties, to supervise the activities of banks and the impact those activities have had on the stability of the European economy. Both of them spoke as if the problem today was solely one of Government finances, when it is also a problem of bank finances

THE GERMAN AND DUTCH PROPOSALS TO CHANGE THE EU TREATIES - HOW RELEVANT ARE THEY TO THE PROBLEMS WE FACE?

But what of the more detailed proposals for Treaty change advanced so far. How relevant and helpful are they? It is suggested that we must amend the EU Treaties, because it is argued that the existing Treaties either

- a) prevent us doing what is necessary to resolve the situation, or
- b) provide us with insufficient assurance that we will not get into the same difficulties again.

The German CDU has demanded Treaty changes to provide for

- * automatic sanctions for breaches of the Stability and Growth Pact (3% deficit and 60% debt/GDP ratio),
- * a procedure for insolvency of EU states,
- * the direct election by the people of the EU of the President of the European Commission,
- * taking away the exclusive right to initiate EU legislation from the Commission, and allowing the Parliament and the Council an equal right with the Commission to initiate legislation,
- * more seats for bigger countries in the European Parliament based on their bigger populations.

They also want Europe to unilaterally introduce a tax on financial transactions.

The Dutch Prime Minister has suggested Treaty changes that would

- * allow a European Commissioner for budgetary discipline to force states running excessive deficits adjust their policies and
- * to impose sanctions including reduced payments from Cohesion and Structural Funds, national budgets requiring EU approval before introduction, suspension of voting rights in EU institutions, and ultimately expulsion from the Euro zone.

It is important that any proposals for Treaty change are based on an honest appraisal of what our problems actually are, and are not put forward as tokens to soothe domestic opinion in particular countries. Our problems are too serious now for that sort of thing.

Given that Treaty changes in the EU require all member states to ratify them, the way proposals are put forward is almost as important as the proposals themselves.

If proposals seem to be one sided, or to emanate from a small cabal of big countries, rather than from an inclusive process of which all member states have equal ownership, then the proposed Treaty changes may be doomed from the start, whatever their merits.

On the specifics of the CDU and Dutch proposals, I would respond as follows.

THE CDU PROPOSALS

The difficulty with automatic sanctions for supposed breaches of the Stability and Growth Pact is that, if the country on whom they were to be imposed objected, the dispute would go to the European Court of Justice, not to the Council of Ministers for arbitration. Breaches of the Pact would include questions about whether assumptions about future economic growth and thus revenue were too optimistic, the point at which a country was on in its economic cycle, and the like. These are questions on which economists, who are studying these matters all the time, usually cannot agree. There is little chance that the judges in the ECJ, many of whom have no background at all in economics, will make sensible judgements in such cases.

A treaty provision for the insolvency of states, as suggested by the CDU, will be very difficult to draft and will be highly controversial. There may be some merit in establishing rules in this field, but I wonder if this is the time to be doing it. The issue will not be being debated in an academic setting, but in the midst of febrile market conditions. There is a strong risk that the twists and turns in a public debate on the state insolvency will have a negative and unintended influence on the markets.

We should not forget that, when the issue of so called private sector involvement in resolving the Greek debt crisis was first mooted by Germany, it had an immediately damaging effect on the capacity of some other smaller countries to borrow.

CDU PROPOSAL FOR DIRECT ELECTION OF EU PRESIDENT MOST WELCOME

The direct election of the President of the European Commission by the people of Europe is a very good idea. I advocated it when I was President of the European Council in 1996, and again when I was a member of the Praesidium of the Convention of the Future of Europe. Interestingly, the only member of the Convention who gave the proposal any support at that time was George Papandreou. It is very good that the CDU is supporting this proposal now.

A direct election of this kind is what we need to create a genuine European demos, or sense of shared destiny, among EU citizens whatever their nationality or language. Without such a demos or shared identity, we will be unable to persuade Europeans to make sacrifices for one another, and that is something we need if Economic and Monetary work.

BUT CDU ATTACK ON COMMISSION VERY DANGEROUS

On the other hand, the CDU proposal to take away from the Commission the exclusive right to propose legislation, and to require it to share that with the European Parliament and the Council of Ministers, is a thoroughly bad idea.

It would weaken the Commission even further than the rampant intergovernmentalism of Europe's response to the financial crisis has already done.

The European Commission seeks to put forward proposals that will command support from all countries, large and small. It formulates compromises in advance.

If the Parliament and the Council could table competing legislative proposals on the same subjects as the Commission, this would make the search for subtle compromises much more difficult. It would enhance the power of the bigger delegations of the bigger countries in the European Parliament and would encourage crude nationalistic majoritarianism in that body.

The Commission is the protector of the interests of smaller member states within the EU, and this CDU proposal will be seen by them as provocative and subversive of the community method on which the EU was founded.

CHANGING REPRESENTATION IN PARLIAMENT WOULD UPSET A DELICATE COMPROMISE

The CDU proposal to increase the relative representation in the European Parliament of countries with bigger populations, but without reducing the extra voting weight that bigger countries enjoy in the voting system of the Council of Ministers, overturns one of the central compromises reached in the drafting of the European Constitution and the Lisbon Treaty.

The CDU should remember that, even if the United States which is a fiscal union, all states have equal representation in the Senate while populations have equal weight in the House of Representatives.

Under the Lisbon Treaty, the EU has struck a similar compromise. Bigger states have bigger representation in both the Parliament and the Council, but there is a system of "degressive proportionality" which compensates smaller states by giving the proportionately bigger representation than their population would strictly justify.

I cannot understand why the CDU wants to reopen this difficult matter, unless of course it wants to use the proposal as a negotiating weight to gain traction on some other issue. Frankly, I think our situation is serious enough without that sort of gamesmanship being introduced.

A FINANCIAL TRANSACTIONS TAX

The suggestion of a financial transactions tax has populist appeal. It may slow down financial transactions and allow a little more time for reflection in the markets. It would curb automated transaction systems by making unduly frequent buying and selling slightly more expensive. It could provide the EU with a new source of revenue, which would be very welcome.

But It would also lead to financial sector activities moving out of Europe, and the tax revenues that those activities generate for EU states going into the treasuries of non EU countries. Given that unanimity must be obtained for this proposal to go through, I wonder if it is not, like the proposal to redistribute seats in the European Parliament, being put forward as a negotiating ploy . Again, one must ask if this displays the sort of seriousness that our parlous situation requires.

THE DUTCH PROPOSALS

Turning to the Dutch proposal to enhance the Commission's control over the budgets of states running excessive deficits, it is hard to argue against the principle of what they are seeking to achieve. The CDU has argued that fines for excess borrowing should be automatic.

But one might wonder how urgent the proposal is.

Financial markets are already imposing very harsh discipline, through demanding higher interest rates of countries with excessive deficits.

It will be a long time before any EU country will ever again be able to borrow money at easy rates of interest unless their fiscal policies are demonstrably sound. Do we really need to reinforce what the markets are already doing with Treaty changes at this stage?

It is also worth noting that the reverse majority procedure now applies to both the Excessive Deficit and the Excessive Imbalance procedure. So a country, that is liable to be fined for running an excessive budget deficit, or an excessive balance of payments surplus or deficit, will automatically have to pay a fine, unless it can persuade a qualified majority in the Council NOT to let the fine go ahead. Perhaps we should see how that new procedure works before going for Treaty change?

In any event, levying a fine on a country, that is already in financial difficulty , will add to the difficulties. It will be too late to be an effective deterrent

CUTTING STRUCTURAL FUNDS?

The Dutch proposal to reduce payments from the Structural Funds to countries with excessive deficits will fall more heavily on poorer countries than on richer ones.

Excessive deficits or economic imbalances in richer countries can be just as damaging as they can be in poorer countries, perhaps more so. For example, the Netherlands is less reliant on structural funds than is Estonia, so a proposal to reduce structural would hurt Estonia proportionately more than it would the Netherlands, even though their excessive deficits might be of the same proportionate scale. That is unbalanced.

The proposal that budgets of deficit countries require advance EU approval is also potentially unbalanced.

One country can only run a trade surplus if another country runs a deficit. If a country is deliberately managing its economy in order to run consistent surpluses, it is contributing to deficit problems of other countries. That needs to be subject to EU surveillance too.

DUTCH PROPOSAL TO SUSPEND VOTING RIGHTS IS NEO COLONIALIST

The proposal by the Dutch Prime Minister to suspend the voting right in EU institutions of a country which has excessive debts or deficit is tantamount to reintroducing colonialism within Europe, because it would involve imposing decisions, in which they have had no vote, on countries who joined the EU precisely because they thought it was a democratic organisation. The existence in 21st century Europe of a mentality that would make such a proposal is deeply troubling.

I am unclear about the merit of changing the Treaty to allow for the expulsion of a country from the euro zone. It would imply that the euro itself is a temporary expedient. It would aggravate speculative pressure, without any compensating benefits.

CONCLUSION

I believe the proposals from the CDU and from the Dutch Governments to change the Treaties are not adequate to the problems we face, and in some cases are a distraction.

The so called six pack proposals, recently agreed go a long way to strengthen disciplines on fiscal policy, and do not need Treaty change. They should be given a chance to work, before we contemplate additional Treaty changes for control of national budgets.

But the CDU proposal for a direct election of the President of the Commission does deal with an important problem that underlies our present problem, namely the lack of a sense, on the part of ordinary Europeans, that they can, through their vote, influence the direction of EU policy.

If citizens could directly vote the President of the EU in or out of office, that will give them a much more direct sense of control of the direction of the EU than they get now from just voting for their local or national MEPs.

None of the proposals on the table so far deal with the issue of banking, which is at the heart of our economic difficulties today. It was foolish lending decisions by banks that caused our problem.

The original Maastricht Treaty of 1992 envisaged the ECB taking an overall role in overseeing the prudential supervision of banks, especially banks that were lending across borders within the euro zone. This provision in the Maastricht Treaty was never brought into effect, because activating the ECB's powers in this matter required unanimity. Some countries did not want anyone else enquiring into their banks, and that reluctance continues even to this day.

Any Treaty change now should include

- 1.) much tighter EU wide supervision of banks,
- 2.) restriction on the size of banks, and
- 3.) an EU wide deposit guarantee scheme.