WALTER HALLSTEIN-INSTITUT FÜR EUROPÄISCHES VERFASSUNGSRECHT

FORUM CONSTITUTIONIS EUROPAE

FCE 07/11

STRUCTURAL CONDITIONS FOR A VIABLE EMU

JAN KEES DE JAGER
MINISTER DER FINANZEN DES KÖNIGREICHS DER NIEDERLANDEN

Vortrag an der Humboldt-Universität zu Berlin

am 24. Mai 2011

- ES GILT DAS GESPROCHENE WORT -

Das Forum Constitutionis Europae ist eine gemeinsame Veranstaltung des Walter Hallstein-Instituts und der Robert Bosch Stiftung.

Meine sehr verehrten Damen und Herren,

es ist mir eine große Ehre, hier heute an dieser auch in den Niederlanden so berühmten Universität im Herzen Berlins zu Gast zu sein. Einige meiner engsten Mitarbeiter haben hier studiert. Der berühmteste Niederländer, der an der Humboldt-Universität seine Spuren hinterlassen hat, ist natürlich der Chemiker Jacobus Henricus van ’t Hoff. Er erhielt im Jahr 1901 den ersten Chemie- Nobelpreis, und zwar für seine bahnbrechende Entdeckung der Gesetze der chemischen Dynamik. Ein Nobelpreis, auf den Deutschland und die Niederlande noch immer gemeinsam stolz sein können. Der Wissenschaftler stammte aus den Niederlanden, doch sein Forschungsumfeld, das ihn zu diesen außergewöhnlichen Leistungen beflügelte, fand er in Deutschland. Ein schönes Beispiel dafür, was alles möglich ist, wenn die Chemie stimmt …

Mit dieser Gemeinsamkeit zwischen Deutschland und den Niederlanden möchte ich zum Thema des heutigen Tages überleiten: die Zusammenarbeit in der Europäischen Wirtschafts- und Währungsunion. Ich bin es gewöhnt, im europäischen Rahmen über dieses Thema auf Englisch zu sprechen. Ich hoffe, Sie verzeihen mir, dass ich deshalb jetzt in dieser Sprache fortfahre.

It’s now more than a year since the historic weekend of 8 and 9 May 2010, when we decided to set up the temporary European Financia Stability Facility, or EFSF. Over the past year both European politicians and civil servants have lost a lot of sleep trying to bring the debt crisis in the Economic and Monetary Union under control.
Several EU countries are struggling with sizeable deficits and debts. But the problems in the eurozone seem to be having the biggest impact on sovereign credit and credibility.
And despite the major benefits the euro has brought us, that is no accident.
I don’t want to confine myself to looking at the present crisis mechanisms, guarantees and policy conditions.
I want to dig deeper. Let’s start by identifying the principal causes of the situation we are in now. And then look at what we need to do to steer EMU permanently into calmer waters. Economists like to assess EMU in terms of the well-known Optimum Currency Area theory of Robert Mundell. Essentially this is a list of all economic and policy conditions that can be deduced from the theory of markets and factor allocation in order for regional or national economies to adopt a common currency.

Of course, no one predicted the crisis.

But taking Mundell's list as a starting point, I think it should now be recognised that we underestimated the complexity of the conditions under which a currency union can work.

Consider the conditions for optimum cohesion, such as factor mobility and price flexibility, resulting from the integration of goods, labour and capital markets. Such matters are sensitive and often problematic. Likewise, the level of convergence in growth, inflation, government finance and interest rates that is required and achieved at the time of joining, has not proven to be a sufficient condition to guarantee that from there on things will improve further. And while enhanced capital mobility has brought advantages, it has also created a highly integrated financial sector that requires further coordination amongst us, for example with respect to financial supervision.

So you might conclude that we only have one option: to move towards a political and fiscal union and an explicit redistribution to compensate for these imperfections. The term, in other words, that is probably the most dreaded in the German debate on EMU: That of the Transferunion

But for me, this conclusion is unacceptable. I don't believe in EMU as a transfer union, either politically or economically. If we were to simply decide that this is what we need and impose, we would achieve very little. Political union is the superlative state of a monetary union, presupposing a cultural and political identity. Moreover it would have the wrong effect.

Countries would have no incentive to carry out the necessary reforms and make their economies more competitive. This approach would be bad news for the member states that need reforms, but for EMU as well.

So I oppose the simplistic conclusion that a political union is the only option. I prefer to paint with a more subtle palette, to show the problems in more depth.

Let's start by acknowledging that in the foreseeable future, Europe is unlikely to become an optimal currency area by Mundell's criteria. We have deliberately decided not to opt for a political or fiscal union. And we've done so on good grounds.

We cherish our cultural and structural differences, and place limits on the uniformity of our economic and social institutions. That's what makes Europe what it is. So let's drop the word optimal in favour of viable. We don't need an optimal currency area, nor are we trying to build one. We should strive for lastingly viable minimum conditions, while recognising that the original conditions for EMU were too limited, and that our commitment, even to those conditions, has proven insufficient. That is why the remainder of this speech will focus on what EMU needs in order to become and remain a viable currency area. My core message is that, to secure a viable future for the euro, we need to restore credibility, and set higher common standards for governance and convergence in competitiveness.

We will have to work very hard to restore confidence in the euro area and thus in the euro itself. We will have to be far stricter in calling one another to account, and we will have to do so in more areas. And we will have to achieve convergence in competitiveness and strive not for an average of competitiveness but for excellence in the world market. And finally, where there is the risk of spillovers, we must take action.

As former EU Commissioner Frits Bolkestein observed, a statesman has only two guiding lights: history and reason. Therefore, we need to recognise that the current plight of the euro is partly our own fault.

Now is the time to learn from past mistakes. We should admit that our coordination of government finance has not been robust enough. Likewise, we were too optimistic about the degree of convergence already achieved, and in thinking that it would only increase with time. Resilient differences in inflation under a single monetary policy caused real interest rates to diverge. These in turn encouraged imprudent behaviour and the creation of economic bubbles. Moreover, instead of convergence, we are now seeing divergence in growth and competitiveness. We wrongly believed that the convergence criteria sufficed as a means of testing the lasting presence of structural conditions necessary to successfully participate in the euro. And we were naive to believe that agreements considered to be binding, would in fact be kept over the whole cycle, and even under exceptional circumstances.

The most worrying fact in the present context is that we seem to be constantly fighting against a lack of confidence. The large and increasing spreads in interest rates on national debt in EMU countries demonstrate this clearly.

And I would remind you that confidence is the pivot around which the world of money turns.

Economists as ideologically distant as Milton Friedman and John Maynard Keynes liked to refer to the Micronesian island of Yap to highlight the fact that money and confidence are in fact the same thing. The Yap currency was the rai. The rai didn't fit into your wallet. And that is putting it mildly. They were gigantic, heavy limestone discs, which stayed in the same place generation after generation. Some even lay in the sea. Not only their size but also their history determined their value. It was not the stones themselves that were the means of

exchange. Rather, it was the value that the people of Yap assigned to them. Things are no different in our Western society.
Money may be:
a piece of paper;
a computer code;
But we really pay each other with confidence.

Let me quote Barry Eichengreen on this: ‘Credibility is the confidence invested by the public in the government’s commitment to a policy.’
Every day we implicitly ask our citizens for this investment of trust. So, restoring confidence is the ultimate challenge facing the euro. Confidence that all EMU countries strictly hold themselves and one another to account. Confidence that national estimates of growth, budget deficits and inflation are reliable.
And above all, confidence that, within EMU, an agreement is an agreement and our words reflect the facts, as we know them. It is deeply worrying that two weeks ago Wolfgang Münchau in his column in the Financial Times stated that he frankly no longer believes
any statement by any EU-officials in respect of the crisis. In our efforts to dampen market reactions, we have put our own credibility at risk.
Ladies and gentlemen,
Our present situation reminds me of a famous remark that Konrad Adenauer once made in the Bundestag. He said: ‘Wir leben alle unter dem gleichen Himmel, aber wir haben nicht
alle den gleichen Horizont.’
We can only restore confidence by acting together and by being serious about it.
The crisis will not let us off the hook easily. Restoring confidence is the only way to keep the euro intact.

To achieve this, all countries will have to stand shoulder to shoulder as regards both governance and convergence towards greater competitiveness.
We must broaden the fundamentals under the stability and sustainabilit of EMU.
Currently, the stability of the euro greatly depends on the triple-A countries. I believe this is especially true of Germany and the Netherlands. Yesterday I visited the new BMW plant in Leipzig. I was impressed by this practical example of the powerful and flexible
German economy. By limiting wage increases in recent years while investing in innovative

technology, the re-unified Germany has built a resilient economy. Even now, so soon after the crisis, this is bearing fruit. The recently published macro-economic figures for the first quarter of 2011 are inspiring and give cause for optimism. Trade between Germany and the Netherlands is not only extensive, it is enormous.

And while it has been growing since at least 1831, when the Treaty of Mainz liberalised Rhine shipping, it is flourishing today thanks to the internal market and the euro.

If there are two EMU countries that should logically stand together, they are Germany and the Netherlands.

In the past, sadly, our countries have sometimes lost sight of one another.

That happened in November 2003 when France and Germany joined forces to oppose the strict implications of the Stability and Growth Pact. The Netherlands was very disappointed about this. And I strongly suspect that Germany, too, now looks back at those events with mixed feelings. Fortunately, this did not stand in the way of our working together in the years that followed. And I'm sure that our German friends see the Netherlands as a kindred spirit and partner. In addition to restoring confidence our challenge in the short term is of course to tackle the debt crisis. We need to do so to safeguard the stability of the eurozone.

We need to be pragmatic and fair, but also very strict. For the sake of the eurozone, and thus also for Germany and the Netherlands, we must induce Greece to do whatever is needed to restore economic and financial stability. Insufficient action could unleash a chain reaction in the eurozone, which is only now gradually recovering from the financial crisis.

There can be no question that Greece must comply fully with the terms of the loans it has been granted.

So the next move is up to Greece.

For the sake of the euro and also for its own sake, Greece needs to cut its spending more, carry out more economic reforms and privatise a very large portion of its state-owned companies so that these can flourish and generate growth.

Safeguarding the stability of the eurozone – after everything to prevent a crisis has failed – is the idea behind the creation of a permanent crisis mechanism. Here too, we must be pragmatic, but again very strict.

So we should insist that the IMF be involved, stringent policy conditions be set and, if necessary, the private sector should share the burden. There cannot be any form of unconditional financing, nor any subsidising in the shape of a eurobond. To safeguard the

stability and sustainability of the eurozone, each and every member state, all of us, have a duty to undertake the so needed reforms and keep one another in line.
To this end we need to respect and extend the rules of economic governance in Europe.
But to be honest, during the first ten years politicians neglected the debt criterion; mainly because it was not formulated clearly. That means insisting on the new rules of the Stability and Growth Pact; Complying with the rules means that countries work to build buffers in good times and target their medium-term objective of solid budgetary finances. And it means that a debt of 60% of GDP should be the upper limit.
That is the rule we will return to and observe. Every country with a higher debt will be required to eliminate the difference within twenty years.

The Dutch government, in which I'm Minister of Finance, intends to meet all EMU norms within its term of office. But respecting the rules that we had, turned out not to be enough. We needed to extend European governance, as the objectives that we once agreed upon have proved to be too narrow. Since the start of the task force headed by Herman van Rompuy we have worked at improving the scope of European governance. The European Semester and the excessive imbalance procedure are a clear step forward and hold the promise of improving our grip. The first may lead to the identification of unrealistic projections at an earlier stage, while the latter requires us all to strengthen our competitiveness and pop credit booms or other bubbles as they start to emerge.
Furthermore, we will adopt the European directive on fiscal frameworks, which will require countries to build realistic medium-term projections. Also, obligations on European governance should be enshrined in national law.
When countries – despite recommendations and warnings – do notcomply, sanctions will apply.
This will happen almost automatically, with reversed quality majority voting.
We have also agreed that the council will, in general, follow the recommendations of the Commission. In short: our aim is that the rules we have all signed up to should apply as automatically as possible and not be subject to political judgement.

Finally, and over the longer term, we must radically address the issue of competitiveness across the euro area. It is key that all countries conform to the best practice and ensure that their levels of competitiveness converge on the standards of the best performing countries. This is what I mean when I say that we need to achieve convergence in the eurozone. This is a conditio sine qua non. Without it, the euro area is doomed to fail.

Ladies and gentlemen,

Historians tell us that currency arrangements between sovereign states have a limited lifespan. And from the 19th-century Latin and Scandinavian currency unions to the Bretton Woods system, that appears to be true. Yet in none of these cases were the economies of the countries involved connected by the extensive economic links and governance mechanisms that exist in the euro area.Nor did they share a single monetary authority and an ideology fuelled by the deepest trauma of modern history.

All this makes the risk of a decline in EMU completely unacceptable for civil society and should galvanise us into overcoming the current crisis. The Dutch government believes in a viable monetary union without a political or fiscal union, for which there is no support.

The premise for this position is credible commitment to the conditions for participation, a deepening of European governance, and a lasting convergence in competitiveness of economies.

And most of all we will have to be far stricter in calling one another to account, in more areas.

In short, we must raise the bar, or face the consequences.

Thank you.