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From monetary union to differentiated integration

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The Brexit has put the question of the final goal of European integration in question. The debt crisis of the Eurozone, poor economic and social performance, or the refugee crisis show that current institutions and policies have failed. There is a consensus that major changes are required for the European idea to survive.

Our paper is composed of three parts. The first part provides a diagnosis for the failure of adjustment policies within the Euro zone. The second part of the paper explains why we cannot accept the binary logic, either more deepening of integration or total disintegration, eg falling back into a system of nation states. Part three of the paper presents the third possible scenario, i.e. differentiated integration.

I The trap of the single currency

The euro resulted from a political compromise between France and Germany which paid little attention to economic realities. France wanted to avoid simply being integrated into an expanded mark zone. Germany agreed to the elimination of the mark in return for the acceptance of its reunification but imposed its own rules. The initial compromise of 1992 presupposed a limited eurozone because it was thought that the restrictive Maastricht criteria for inflation and public finances would prevent the two main southern countries – Italy and Spain – from participating. But the adjustment efforts made by these countries in the first half of the 1990s so as not to be left outside allowed them to qualify although the criteria were far from being strictly satisfied, especially as regards the level of public debt in Italy.

In fact, a convergence of inflation rates and interest rates did take place, but inflation and real interest rates differentials were not eliminated among northern and southern countries in the eurozone. At the beginning of the 2000s the debt securities of Greece, Spain or Portugal appeared to be equivalent to German debt securities. This led to an investment boom, stimulated by low real interest rates, with capital flowing in from northern Europe, including massive speculation in Spanish and Irish real estate. Growth was slower in Germany, held back by higher real interest rates and wage adjustments under the Schröder reforms of the early 2000s. This apparent convergence disguised important imbalances. There was a wide divergence in unit wage costs with, in relative terms, big increases in Spain, Ireland, Greece and Italy and falls in Austria, Finland and, above all, Germany. Current account imbalances widened enormously, with deficits in the South in contrast to surpluses in the North. But these current account disequilibria were regarded as a secondary matter in the monetary union where the overall current account was close to balance. Rather, the key issue for governance in the eurozone was seen as government deficits and debt. Here things seemed to be going well: European countries had reduced their public sector deficits; Germany returned

to balance in 2007 while Spain, Portugal and Ireland were regarded as models of budgetary rigour in complete conformity to the Maastricht norms.

On the eve of the financial crisis the wide disequilibria due to heterogeneity appeared to be hidden. They were characterised by an undervalued euro for countries in the German bloc and an overvalued euro for the countries of southern Europe (including France) while for the eurozone as a whole the euro was close to its equilibrium value (Duwicquet et al., 2013). These misalignments of real exchange rates among the countries of the euro zone were the source of important transfers at the expense of the export sector of countries with an overvalued exchange rate and to the advantage of export sectors where there is an undervaluation. Taking into account the size and the degree of openness of the different economies it can be estimated that, for a misalignment of 10% in the real exchange rate, the implicit transfers are of the order of +4% to +5% of GDP for Germany and -3% to -4% for France, Italy and Spain.

These misalignments of exchange rates reflected the structural heterogeneity between northern and southern Europe with France in several respects in an intermediate position. The North of Europe is more specialised in manufactures while the South of Europe is increasingly specialised in non-tradeable goods. The size of industrial firms is clearly smaller in Greece, Portugal, Spain and Italy than in the rest of Europe. In general, small firms have lower productivity. Innovation efforts are significantly weaker in the South than in the North and the active population is clearly less qualified (OECD, 2010).

The incoherence of the eurozone regime

The financial crisis of 2008 worked to reveal these disequilibria. Our contention is that a monetary union between heterogeneous countries without other adjustment mechanisms than wage deflation can only lead to divergent evolutions and rising intra-European disequilibrium with a polarization of economic activity on the most competitive bloc. Facing the euro zone crisis European governments have generalized austerity policies in order to achieve internal devaluations and reduce the public deficits. New European institutions and rules were settled down to procure the needed financing (European Stability Mechanism, Outright Monetary Transactions, Banking Union, Quantitative Easing, Capital Markets Union). But the monetary and financial federalism monitored by the ECB and combined with the rules of the Fiscal Treaty cannot solve the euro zone crisis.

The non-conventional monetary policy of the ECB is more limited than it seems. QE is not allowed to absorb more than one third of the debt of any issuer of bonds and bond purchases have to be in proportion to the economic weight of the country concerned. This rule limits the assistance which can be given to countries in difficulty and makes it difficult over time to keep the promise of “*whatever it takes.*” The limits on purchases of German bonds are close to being reached – it is the largest economy but with a declining amount of debt – while it would be easy to buy more Italian bonds but that would exceed the Italian quota. Moderation of the rules would be necessary (raise the fraction of debt that can be bought to 50% for example, and permit bond purchases above the economic weight of the country concerned) but this would be difficult to negotiate. The provision of emergency liquidity assistance

(ELA) to banks which are solvent but under pressure raises a further problem: the decision is taken by the central bank of the country concerned and not, as would be logical, the EU-level authority responsible for banking supervision. Here again we see the incomplete nature of the federal project and the different levels of confidence in different countries.

ECB policy poses a further problem. The ECB has helped to put out the fire or, at least, to stop it spreading. QE has only been effective to a limited extent. By adding to liquidity the programme was meant to reinforce the low interest rates and to encourage the banks to increase their loans or to buy financial assets. It has had only a limited impact on real growth and inflation. Most of the liquidity created by the ECB has gone towards financial markets, both in the eurozone, pushing up the price of assets, and outside, with a corresponding outflow of capital and a decline in the euro exchange rate. The very low interest rates did not have a strong impact on productive investment because of the low level of demand and a climate of uncertainty which favours the holding of financial assets. The two main channels through which QE has affected the economy are the boom on financial markets which can give rise to wealth effects on expenditure but also lead to dangerous asset price bubbles, and the depreciation of the euro which can advantage sectors producing tradable goods and services. All in all, the unconventional monetary policy implemented by the ECB had limited effects on the real economy.

Given the weak state of the economy, equity prices seem very high with the possible development of a financial bubble. The risk of a bubble on bond markets is even more worrying. European banks and central banks have bought enormous quantities of bonds. If bond prices should fall because of a political crisis, because of financial problems in one country or because interest rates rise in the rest of the world there could be significant losses on bond holdings which, in the last resort, would impact on the central bank. The central bank would have to recognise the losses in its accounts and this would require it to be recapitalised. In itself this can be a difficult operation. It would be all the more difficult in the eurozone because, unlike the Fed in the US, the central bank is not backed by a single state but by seventeen. Recapitalisation of the European system of central banks would be financed by all member states in proportion to their share in its capital while it might be only one country, or a limited number of them, which was involved in the losses on bonds. This could make the operation even more complex.

Finally, even though current account imbalances have been reduced, overall payments imbalances are still widening. The ECB plays the role of a clearing house and records in its TARGET2 system (Trans-European Automated Real-time Gross settlement Express Transfer) the deficits of the South and the surpluses of the North, that is for each country the sum of its current account and net inflows of capital. Until 2008 the current account deficits of the South were matched by capital inflows so that the TARGET2 system as a whole was close to balance. Since 2009 this has no longer been the case. The deficits and surpluses now being registered in TARGET2 reflect net outflows of capital from South to North which cannot be sustained indefinitely because they arise from a loss of confidence by investors in the countries concerned. These deficits rose even further in 2016 and reached very high sums for Italy and Spain because of the size of the two countries. In the American case, where

Fedwire is the equivalent of TARGET2, supervisory mechanisms exist at the level of the regional central banks. Balances are brought back close to equilibrium every year through incentives for local banks to help finance intra-regional imbalances and, above all, by asset transfers among the regional central banks. Such mechanisms do not exist at the level of the eurozone and, in present circumstances, it is hard to envisage them, given the incomplete character of European integration.

In spite of everything, a sustainable regime?

In a context of continuing tension, some modifications can be seen since 2015. Wages have risen more in Germany under pressure from IG Metall and infrastructure investment (becoming in any case increasingly necessary) has been relaunched. Although these changes are much less than Germany could achieve they head in the right direction. At EU level the Juncker Plan, launched in 2015, contains some very impressive numbers, but one should not be mistaken. In theory 315 billion euros of additional investment are expected by the end of 2018, that is 0.8% of EU GDP and an increase in investment of 4% per year. In practice the Juncker Plan is to be managed by the EIB where a special fund has been set up but endowed with only 21 billion euros (of which 16 are being raised from an existing line of credit). The EIB can lend up to 60 billion by borrowing. The rest must come from the participation in the plan of other public or private investors. Overall, although the size of the plan has been increased to 500 billion and its period of operation extended to 2020, the value added by the plan is very small. These difficulties remind us of the problems faced by European-level plans to relaunch investment since the 1980s.

Macroeconomic conditions in several countries have improved somewhat since 2015, sustained by depreciation of the euro, the fall in petroleum prices and a slight relaxation of the severe budgetary constraints imposed the Commission. One should not build false hopes on this slightly sunnier interval – and this for two reasons. Firstly, although a real recovery is taking place in the eurozone in 2017, unemployment remains very high in the South of the zone and income inequalities very wide. All this leads to persistent social tensions. Secondly, destabilising factors remain, with high levels of both public and private debt, fragile banks and the threat of higher interest rates to come. There continue to be serious misalignments of real exchange rates among the countries of the zone, mainly at the advantage of Germany. For countries where the real exchange rate does not adjust, this means the slow asphyxiation illustrated by the French and Italian cases. The sustainability of the euro zone growth regime in the absence of thoroughgoing reforms remains a completely open question.

Persistence with a growth regime which performs so badly may seem surprising. It is to be explained by the interests of two groups – on the one hand the countries of northern Europe on the other the European elite. The first, grouped around Germany, benefit from an undervalued currency and do reasonably well even if they are affected by the weakness of the southern countries. The small, very open economies can also adapt more easily. The second, the “European elite”, consisting of the dominant strata in industry and finance and the European technocracy, uses the crisis to deepen and extend neo-liberal policies: increased flexibility on the labour market; reduction in social expenditures leading households to resort increasingly to private insurance, tighter budgetary frameworks to reduce the role of the state

and relaunch the process of privatisation, refusal to increase taxes on financial revenues, high incomes or big wealth holdings, which have all seen considerable tax reductions, failure to impose adequate constraints on the financial sector. These express also the relative indifference to developments in the internal market of the big European corporations which are more global than European.

II The binary logic of more or less EU integration: learning from its limits

The binary logic, either even more deepening of integration or total disintegration of Europe, eg falling back into a system of nation states is misleading as it lacks a proper political background, eg a full vision of the current situation in democratic countries. The “disintegration “ of Europe as proposed by rising right-wing movements is clearly a vote of protest. It may imply some return to the system of European nation states, as it existed in the nineteenth and the first half of the twentieth century, but it is not clearly advocated like that and it often turns out to be an internal issue of conflicts when such vision are explicated¹. ². Apart from the economic and political cost of disintegration, there are two fundamental reasons why the solutions advocated by right-wing movements, such as the French Front National, cannot work. First, they all stick, although with nuances, to the neoliberal paradigm. Hence, their economic receipts will not solve the social problems which are behind popular dissatisfaction and the votes of protest. Second, a new fundamental fact has come into play, which did not exist in the first decades of European integration : globalisation. Although this process does not mean the end of the nation state, it had changed the relations between them. The economic, juridical, cultural and other interrelations between nation states have become extremely dense. Moreover, new issues have emerged, such as climate change and refugees, which cannot be solved at the level of nation states. Hence, cross-border cooperation and policies are required.

The deepening of Europe somehow can be submitted to similar critics as it cannot rely on an explicit political background on which all countries would have agreed as the core of the measures to be taken to go ahead. A “more Europe” approach is unrealistic in the near future. All opinion polls suggest that, even in the more pro-European countries, a majority of citizens are in favor of a moratorium in the integration process. There are two fundamental reasons why the deepening of integration, in particular the federalist approach, cannot work in Europe today. The first category of reasons has to do with the fact that the nation state remains the dominant form of organization of societies, both worldwide and in the EU. The last decade has shown that supra-national structures and procedures could not deliver what was needed to overcome the crisis. However, the nation state is an ambiguous phenomenon leading to strong social relations between its citizens, but also to dangerous nationalist behaviors, such as xenophobia and racism. This shows that one of the great challenges of the 21st century is to find new forms of hybrid political organizations based on nation states and

¹ Even the idea of getting out of the euro has been a conflictual issue within the Front National in France last presidential election.

² It does not mean that there is no attempt from extreme right wing parties to do so and try to produce a common vision , but it is still very preliminary and end up most of the times stressing differences and inconsistencies as shown again this summer at a gathering in Bekescsaba (Hungary).

supra-national (or international) cooperation. A second major obstacle to the “more-Europe” approach is the economic heterogeneity of member countries which has been stressed in the previous section, and led us to consider the policies of the present monetary union as unrealistic. Putting an end to austerity policies for instance cannot be expressed in one package rallying political support in all members of the eurozone. We need to go beyond the binary logic expressed above and to investigate how this impossibility can be overcome. More explicitly, the question is : how politics in member states can come to some agreement on how to proceed with the EU ? In that respect the scheme used in Aglietta and Leron (2017)³ (and clearly discussed in Grahl (2017)⁴ can be useful. These authors refer to a ternary structure of *polity* (the institutional setting that say who rule and in which manner), the *policies* (which are the usual type measures issued by those in charge (according to the polity of the system) and the *politics* , eg the democratic debates in each country stating what citizens want/expect for their life, those of their children and others , eg how they see their society should evolve. There is a clear dynamic in this structure where politics may initiate some deep changes that would forge polity for a period of time and be followed by sets of policies in accordance with the initial political demand and the polity system installed. This dynamic is in short clearly illustrated in the post war period with a political support for full employment conventions, with the “different” polities attached to each of the specific welfare state in construction. These schemes are bound to evolve along time, especially in a world open to exchanges. International organizations can be seen in similar ways, except that even if they originate from some political expressions at the level of each nation, they in the end turn out to have a political deficit, namely to lack a specific constituency that would help to forge a political base of its own. This default becomes a major drawback when the polity of the international institution is able to develop and increase its juridical power in the simple course of its experience, as it is the case with the ECJ (European court of justice), as claimed by Aglietta and Leron. Such a development is clearly detrimental for the political live of member states as the juridical order of the international institution is becoming unexpectedly too constraining for the member states political activities and projects. Another example of this shortcoming (i.e., inability to develop the “political” base of the international institution) is given for the EU by the relative weakness of the European parliament. To have a more active EU parliament cannot clearly be decided overnight. It can only be the result of a long/complex process that we have to investigate, considering also that it may not be the only way to forge such political base. French president’s Macron proposal to create a Parliament for the eurozone can be interpreted in this way.

The relative weakness of the EU parliament has often been advanced as an explanation for the blockade of the European Union. The decrease in the turn out at th European elections confirm this detrimental impact. One could also notice the relative absence of European political parties directly in the UK debate over Brexit ..or in direct support of the Greece government in the 2012 crisis. It shows, if needed, a lack of integration of the national political levels. Similar remarks could be done on the actions of the trade unions where European associations found difficult to increase their cooperation. Even looking at the rising

³ La double démocratie : une Europe politique pour la croissance. Editions du Seuil .208 pages

⁴ Euromemo group discussion paper N°1 2017

role in governance issues of NGOs, one can notice that in most cases these organizations remain rather national or jump directly at international levels but less often specifically European⁵. It is not a critic per se of these various institutions, it is simply to question how these extensions of politics at the level of an union can take place. In the aftermath of world war II, the search for peace has certainly been determinant along with the commitment to what has been referred to as Full employment conventions. The creation of the European Community of Coal and Steel ECCS (CECA) was clearly in this line of a claim for peace. The 1956 Treaty of Rome, although very much market oriented in retrospect, was also on this line rather complementary of the full employment conventions. The crisis of the international order of the 1970s led the EU to a new phase, more defensive, eg forced to adjust to the neo liberal phase impulsed especially by the US and the UK....even if it was proposed to the political bases as a phase of predominance of the consumer....all of which petered out and turned into a financierisation phase when finance took the strongest advantage of the liberalization of trade and capital mobility. The enlargement of the EU in 2004, even if it had a strong political base in many countries, further complicated, in accruing the heterogeneity of the union, the development of a political base at the EU level. As it has been assessed many times and especially in the first section of this paper the creation of the euro was highly defensive, rallying countries to a strictly ruled monetary system in a defensive adjustment to the vagaries of a free exchange rates international monetary system. Such monetary regime does not proceed from a preexisting strong social bond. The challenge of the euro was from the start to become one and clearly the conditions of austerity, especially strengthened after, run counter to this essential objective. To reverse what can be seen as a trend of disaffection from the Eurozone, ... and ensuingly from the EU, it is more and more urgent to develop a political base for the EU that could push forward an adjustment of the EU polity that would release the straightjacket that the present EU polity represents with its expansionist juridical order (as denounced with the widening range of action of the ECJ). It is not an easy task but it has to be taken as a necessary condition for any realistic resuming of a strongly socially grounded EU. To forge the required EU political space one would have to take into account the European heritage in terms of culture, education, sciences, ways of urban life, appraisal of country sides and natural environment,...in order to express in relevant ways the kind of future they want to promote, all of which include the type of citizenship they foresee in societies they want to live in. Issues of common concerns expressed in ways making sense for all nationals are to be at the centre of the EU political life. The themes discussed in the EU political arenas being concrete and close to people will leave little room to protest votes. At this stage it seems necessary to launch across member states a political process that would lead to a big convention able to modify the polity of the EU, somehow as it occurred in the aftermath of world war II. This supposes a learning process that may take sometime. The opportunity for such mutual political development can be seen in some major challenges that the EU is more and more facing, as the environmental challenge and the migration challenge...which explains the priority to be given in assessing any realistic alternative route for the EU.

⁵ Comparatively coordination of cities and /or regions seem to be more EU oriented, as they benefit from institutional and financial supports to do so, a potential that should be considered when thinking of building up the political dimension of the EU.

III Towards a differentiated integration

There is a third approach between the return to the system of nation states and deeper global integration in Europe : a differentiated integration, which takes into account the heterogeneity of EU members and is based on voluntary cooperation (Wahl, 2016)⁶. According to this alternative scenario, the future development of the EU and the euro zone should be based on the respect of the plurality and diversity of European countries in order to support a process of convergence and not to increase their disparities. The integration process would be a mix of selective integration and disintegration, organized along principles such as decentralization, regionalization, and subsidiarity.

One of the major advantages of differentiated integration would be to put an end to the unrealistic principle of unity at any price at the lowest common denominator which often leads to paralysis. Of course, differentiated integration will not stop the debate among political orientations and economic paradigms. This debate is necessary for democracy and is part of the “politics sphere” mentioned above. However, it would give the opportunity to break-up with the path-dependency of neoliberal rules imposed by European treaties. If a country opts for austerity, it can implement this policy for himself. But austerity cannot be imposed anymore on others, as it has been done to Greece and others. In that case, the current system would have to be adapted, as we shall see below.

Differentiated integration is more realistic than it seems at first glance, because there already exist several cases where it already works de facto. A first example is provided by the split of the EU-27 into the eurozone and the non-eurozone. The Schengen agreement provides another case of differentiated integration, as well as the split of EU among NATO and non-NATO members. Another case is the cooperation of Poland, the Czech Republic, Slovakia and Hungary in the Visegrad Group. Not to mention the informal differentiation between center and periphery, rich creditor countries of the north and the PIIGS ...

In today's Europe, we can think that differentiated integration should be implemented in two major strategic domains : energy transition and climate action , on one hand, and monetary and fiscal policies, on the other hand.

More precisely the actions taken in the first domain ,eg environment policies, should help to legitimate and thus to facilitate the necessary actions taken in the second domain of monetary and fiscal policies

Environmental issues are certainly a good case to develop a broad agreement convention to be shared by a large number of partners and thus contribute to build up stronger solidarities between member states which are not exposed in similar ways to the threat of environmental disasters. Giving a priority to this process implies that any proposition to get out of one of the regulatory traps, in which the EU is stuck, should be considered in view of its political link with the environmental case as a potential source of political legitimacy.

⁶ Peter Wahl (2016): Between Eurotopia and Nationalism: A Third Way for the Future of the EU, Globalizations, DOI: 10.1080/14747731.2016.1228787; <http://dx.doi.org/10.1080/14747731.2016.1228787>

Looking at the monetary and fiscal adjustment mechanisms which should be at the core of a social bond, but are presently eroding it more than reinforcing it, a pragmatic compromise based on a European investment program, restructuring of Greek debt, a clean-up of bank balance sheets, and indeed the beginnings of a eurozone budget would help to loosen the constraints. But, starting from the present situation, it would be very difficult to achieve such a compromise. European countries are committed to structural adjustments to very different degrees. Spain, Ireland and the Baltic countries have, with great pain, devalued their real exchange rates. Portugal and above all Greece are being strangled. Germany is accumulating its surpluses. France and Italy have, to a large extent, delayed having to deal with the most difficult questions. The most important misalignments of real exchange rates in Europe (an indicator of centrifugal forces) can be found in Germany (for whom the euro is undervalued) and France and Italy (for whom the euro remains overvalued). In Spain and Ireland the euro is no longer overvalued because of the real adjustments which have been brought about. Lastly, none of the measures discussed provides a stabilisation mechanism to respond to future developments if these continue to be asymmetric.

If a compromise cannot be found to increase economic growth in the eurozone and at the same time establish appropriate stabilisation mechanisms, then the situation could develop in two ways. France and Italy could be, in their turn, forced to undertake real exchange rate devaluations, with negative consequences for growth and employment. Or, on the other hand, the question of quitting the euro could be reposed once again in the relatively short run.

Quitting the euro would not be a panacea. It would be a way of not staying locked into ineffective adjustment policies by resolving in the short run the problem of persistently misaligned European exchange rates and by putting in place a mechanism of exchange rate correction and stabilisation in the case of future disequilibria among structurally heterogeneous countries. Short term measures would have to be taken to ensure its success. The exchange rate regime would have to be combined with renewed structural policies. Three European monetary regimes could be envisaged (Mazier and Valdecantos, 2015): a German exit, a system of multiple euros with a global euro remaining at the international level, an euro bancor system. In a permanent regime these systems would allow a better management of the structural heterogeneity of the euro zone. Clearly only a system of multiple euro could be linked with member states efforts in terms of environmental grounded structural policies and should therefore be explored and discussed in the political debates at the levels of MS but also of the EU when such arenas exist. Regarding monetary policy, a new organization of the existing European system of central banks should be considered, with more autonomy given to national central banks to adapt monetary and finance policy to regional situations. These rules can clearly be based on environmental packages. The migration challenge is as pressing as the environmental one and should also be linked with the dynamic of building up solidarities among MS evoked above Migration policies, which are also key issues in national political debates should deserve to be debated among MS and to lead to common stands and cooperation which would help to develop comprehensive policies combining actions in home and host countries. Such cooperation could be organized at national as well as regional levels.

Such global questions require cooperation among country members, but some countries are not ready for common policies. Participation of member states should be based on the idea of variable geometry, that is, coalition of the willing in a perspective of a learning process where countries, not politically prepared can join later on. . To give an example: those who want to cooperate for ambitious targets in CO2 reduction can do this, even if not all 27 member states participate. Existing procedures of the EU can be used to develop such selective cooperation: the Enhanced Cooperation Procedure (ECP) contains in embryonic form the idea of differentiated integration. The ECP allows a group of at least nine countries, representing 60% of the EU population and 75% of the votes in the Council, to establish projects without the others. At present, the financial transactions tax is negotiated in such a coalition of 11 willing member states. A European carbon tax could also be implemented with the ECP. It is important to work in that spirit of learning processes boosted by political debates at all level. Taking seriously these learning processes implies to develop specific schemes of cooperation somehow in the same spirit as done with the will to develop an EU research space that animated the framework programs. As in the case of collaborative research, subsidies on environmental actions or refugee schemes could be tied to a cooperation (sharing of experiences and mutual monitoring) between various European entities, be it cities, regions, NGOs,... This type of policy should also help to reconsider totally the role of non market services, eg not only public services but also all kinds of occupations and organizations, including creation of commons, that could contribute to meet environmental and migration challenges. Indeed it would lead to an increase EU budget but to call only for an increased budget as a conclusion would be a bit misleading when the challenge for social scientists is clearly to show how politics at all levels can invest the above issues. Finding the relevant schemes which can benefit from local political backgrounds is key to move towards societies of full citizenship for all its members, where everyone sees its meaning as an effective social bond, away from the societies of rising inequalities in income and participation in which we seem presently trapped. .