8 WHERE SHOULD THE EURO ZONE 'CLUB' GO FROM HERE? HOW A RETURN TO CREDIBLE AND ENFORCEABLE RULES WILL SUSTAIN THE MONETARY UNION

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Sustained economic governance: back to the roots!

The European Monetary Union (EMU) is certainly in a crisis. Without doubt, the recent rescue plans and packages were necessary to stabilise the euro area and the financial markets in the short run (Bundesbank, 2011). It remains questionable, however, whether this rescue path will lead to a sustained framework of economic governance. There is a huge danger that EMU will follow the wrong path – i.e. a short-run rescue philosophy (Economist, 2011). We argue that the consequences of following the current short-term policy will lead to a future break-up. Therefore, we propose an effective rule-based agenda which can lead the euro out of this mess by returning to more credible and enforceable rules. Learning the lessons from the sovereign debt crisis and identifying the failures that allowed the crisis to emerge are essential to build a new economic governance framework.

The current rescue philosophy of helping the indebted countries by providing guarantees on the one hand and demanding strict austerity on the other hand is appropriate only as a short-term stabilisation measure. This rescue strategy does not solve the structural problems and improper incentives of fiscal policy in the EMU in the long run. There is a substantial danger that policymakers will follow the wrong path because of so-called 'political path dependency'. This policy response

1 The authors are grateful to the two anonymous referees for excellent comments and suggestions. We are responsible for all remaining errors.

might put the whole EMU at risk by creating even more moral hazard and free-riding. A solution to the structural problems requires an answer to the question of why the EMU ended up in this mess.

The frequency of new stabilisation packages for Greece and other countries illustrates that the EMU is at a crossroads. The past and current problems are the existence of a weak and non-credible economic governance framework as well as the insufficient enforcement mechanism of existing rules in respect of fiscal discipline. Since the foundation of the EMU in 1999, there have hardly been any officially defined consequences where countries violate the fiscal rules. Strengthening economic governance in the form of ensuring fiscal discipline through strict conditionality is necessary to sustain the EMU's existence (Salines et al., 2011). The recently proposed six-pack and fiscal compact, however, will not be able to tackle all existing structural problems today and in the future (Herzog, 2011, 2012a).

A consensus exists that a sound framework for governance is a prerequisite for successful and sustainable fiscal policies in the EMU (Schuknecht et al., 2011). Hence, a sustainable economic governance framework needs two arms. Firstly, it needs pre-emptive and depoliticised enforcement mechanisms. Secondly, it needs immediate and tough consequences for countries that are not complying with predefined fiscal rules. In the past three years, the European economic governance framework has changed owing to the developments of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Despite the strict conditionality of the EFSF and ESM, there is neither an agreement on austerity measures, nor an answer as to how to handle countries that are not complying with the rules. There is no doubt, from a theoretical point of view, that both rescue facilities have led to even fewer incentives to countries to bear the consequences of their own fiscal policy decisions.[2] This will further enforce negative externalities

2 Under the ESM, countries pay lower interest rates than under the EFSF and, of course, than in the market. Furthermore, the ECB undertakes outright monetary transactions (OMTs) and thus buys an unlimited number of government bonds if market interest rates are still unsustainable under the ESM grants (ECB, 6 September 2012).

and moral hazard in the European economic governance framework. Thus, a new balance between emergency programmes, fiscal discipline and *ultima ratio* sanctions must be established. Since the first reform of the Stability and Growth Pact (SGP) in 2005, there has been demand for more automatic and independent enforcements in the form of sovereignty limitations when fiscal rules are violated. In this vein we propose a new rule-based framework to sustain the EMU in the long run.

EMU’s performance and a theory of optimal rules

Ever since the Maastricht Treaty and the proposal to establish a currency union in the early 1990s, there has been academic discussion about effective fiscal rules. In addition, there was, and still is, a lively debate about the lessons learned from the two rounds of reforms, in 2003–05 and 2010/11, of the SGP. Despite the knowledge of failed historical monetary unions over more than a hundred years (Theurl, 1992), we argue that a credible and enforceable economic governance framework based on market rules is realistic and will be effective. Experience generated by the analysis of past failures enables us to understand the key requirements of a sound rule-based agenda: credible preconditions and enforceable rules with safeguards.

There are different theoretical approaches to analyse properties of a sustainable economic governance framework in EMU. We will focus on a rational choice and institutional economic approach which reflects the two dilemmas in the euro area. A supranational monetary union requires a framework for seventeen completely different and independent members which are linked by interdependent fiscal policies. The effective combination of these interdependent fiscal policies with the independent central bank is supposed to ensure price stability and financial stability.

This constellation is comparable with a collective action dilemma recognised as Arrow’s Impossibility Theorem (Arrow, 1951). According to the theorem, this dilemma can be tackled either by creating a hierarchy (i.e. centralisation or dictatorship) or by introducing consistent rules via a market mechanism (i.e. decentralisation). Every government and country faces this dilemma in some policy areas, and most of the Western economies solve it with the second approach: i.e. the implementation of a national constitution which automatically enforces certain principles regardless of political expedience. These rules are known in advance and independently enforced. The first option, a European dictatorship, requires a political union with a supranational budget managed by a finance minister. This is not in place right now and will not be in place in the near future. The second option entails a market environment with a consistent rule-based framework. This is an accessible and realistic option in a supranational monetary union because it combines consistent rules and market forces with effective incentives. A national version of this kind of environment already exists in industrialised countries around the globe. The challenge in a currency union is the design of appropriate fiscal rules that can be applied in a supranational context and which relate to existing national rules.

Herzog (2004a, 2012a) argues that the above-mentioned second option, a rule-based economic governance agenda based on a market approach, is a realistic solution for the current and future EMU. This is not only the best tactic for promoting economic efficiency, but also the most suitable option owing to European society's reluctance to countenance European integration and the recent constitutional court judgement in Germany against the development of a European state. Hence, tackling the fiscal–monetary interaction problem requires an effective rule-based framework (Dixit and Lambertini, 2003; Beetsma and Bovenberg, 2000; Herzog, 2004a) that is enforceable. Moreover, the well-known problem of market failures, such as the lack of provision of public goods (in this case economic, financial and price stability) in a monetary union, immediately signals the need for effective institutions and rules necessary for markets to work efficiently. No effective institutions or rules have been in place in the history of monetary union so far, however. Consequently, today's failing of EMU rules is not a market failure, but rather a policy or state failure (Coase, 1960).

Another theoretical starting point for analysing this problem is game theory. If one member state cheats or rejects cooperation with the fiscal rules and gets away with it, other member states will be encouraged to disobey the rules as well. This will unravel the economic governance framework completely. Theoretically this prisoner's dilemma leads to a vicious circle and a loss of confidence from the outside world. The consequences are higher interest rates and an eventual collapse of the euro area.

Again, this is a problem in a supranational monetary union because of inadequate political institutions. Partisan control over fiscal policy usually leads to deficits caused by incentives to overspend (Alesina and Tabellini, 1987; Nordhaus, 1975). Therefore, political agents do not internalise the social costs of debt policy within, and especially across, countries. Overspending is even more critical and amplified in a monetary union owing to fiscal–monetary interactions and further incentives to free-ride in fiscal matters (Dixit and Lambertini, 2003; Beetsma and Bovenberg, 1999, 2003; Beetsma and Uhlig, 1999). Even within a nation-state, politicians have an incentive to overspend. If they are able to ensure that other countries bear the costs of some of that overspending, however, the incentives are even stronger.

The case of Greece has empirically illustrated this effect. The problem is not just apparent in south European states, however: Standard & Poor's recent announcements of downgrades of countries such as France owing to their relatively high deficits and debt levels illustrate that markets are acutely aware of the problem of unsound public finances in Europe more generally.[3] Countries such as Britain and France show no political commitment to a constitutional debt rule, such as exists in Germany and more recently in Spain. The German 'debt brake' works effectively and enhances the credibility of public finances as the

3 Including in Britain, where the issue of imposing costs of deficits on euro zone countries does not arise.

market response has shown during the sovereign debt crisis. Lack of political will and flawed rule design in the EMU due to political horse-trading, however, initially lead to the socialisation of debts, state failure and then the failure of the market itself.

Creating sustainable rules for EMU

The theoretical discussion above provides a basis from which to discuss the practical criteria of an effective rule-based framework for EMU. Kopits and Szymanski (1998) develop characteristics for an efficient and smart rule-based fiscal policy agenda. Following this approach, we provide our assessment of the old and new fiscal rules in the EMU (see Table 3). We use domestic and European data relating to the strictness, objectives and enforcement of fiscal rules. Evaluating the gathered information and categorising it into a ranking-sheet results in our judgement of the twelve characteristics. The table's last column represents an evaluation of the national constitutional debt rule in Germany.

Even if reforms are moving in the right direction, the assessment shows that the old as well as the new economic governance are insufficient in enhancing enforcement and long-run sustainability. Moreover, Table 3 shows the problem of path-dependency, because there is only an incremental change of institutional rules from the pre-existing highly inadequate position. The lack of profound institutional change or a new 'big-bang' solution is part of the crisis of confidence. There is anecdotal evidence that only the close connection of EMU rules to constitutional debt rules on a national level enhances long-run stability in a currency union.

The heterogeneous character of the different EMU members obviously complicates the design and implementation of appropriate fiscal rules. National sovereignty and subsidiarity concerns have to be respected. The rules of member states, however, must be compatible with the goal of a stable EMU if it is to be sustainable. The trade-off between national sovereignty and appropriate rules for a stable EMU requires a clever balance. For example, the growing interaction between

Table 3 **Criteria and assessment of fiscal rules in EMU**

No.	criteria	Assessment of economic governance		
		Old EMU rules	New EMU rules (fiscal compact + six-pack)	Constitutional debt-rule (Germany)
1	Well-defined and consistent	+	++	++
2	Simple and easily verifiable	++	+	o
3	Transparency	+	o	o
4	Flexibility, i.e. temporary country specific adjustments	+	+	++
5	Credibility	–	–	+
6	Preemptive mechanism	–	o	+
7	Avoiding pro-cyclical behaviour	o	+	++
8	Encourage long-run sustainability and solvency	–	o	+
9	Automatic or independent enforcement	–	–	–
10	Compliance	–	?	?
11	Credible sanctions on root causes	–	–	+
12	Linkage to national debt rules	–	+	

++ = excellent, + = good, o = satisfactory, – = insufficient.

monetary policy and the fiscal problems of nation-states automatically aggravates the primary goal of price stability (Art. 105, EU Treaty) and thus provokes moral hazard in public finance. In trying to achieve the balance, we will focus on two key aspects in the assessment of appropriate EMU rules: the encouragement of long-run fiscal sustainability and weak enforcement.

The Stability and Growth Pact does not encourage long-run sustainability and credible fiscal consolidation, especially when that can be achieved at lower cost during economic upswings. This is important. Restraining the growth of national debts may be easier for individual nation-states in better economic times, but there is no incentive for such restraint and no pressure from other member states because there is little obvious short-term damage to EMU until a crisis hits. Enforceable rules are therefore needed – and not just at crisis time. This illustrates the first constructional defect. The two regulations 1446/97 and 1447/97 of the SGP explicitly state that the 'excessive deficit procedure' is triggered only if a country violates the 3 per cent deficit-to-GDP and not the 60 per cent debt-to-GDP threshold. Even the reform of the SGP in 2005 did not tackle this obvious gap.

The paradoxical and unjustified overemphasis on deficits, rather than on long-run debt levels, is explained in terms of a political economic argument. A deficit limit is easier to control than sustainable debt levels. The calculation of primary deficits and the distinction between explicit and implicit debt are, however, tricky.

The absence of a long-run objective and the narrow focus on the deficit undermined the credibility of the economic governance framework and impaired long-run sustainability in several EU countries. The triggering mechanism and narrow focus on government deficit within the SGP were also the reasons why Ireland did not even appear on the radar screen as a potential problem. The existing Stability and Growth Pact has overseen both the accumulation and the impact of private deficits and debt levels across countries in the EMU. In addition, there was and still is no mechanism in place to handle the divergence in current account imbalances (or competitiveness) in the euro area.[4] Consequently, the SGP has failed to promote credibility and sustainability in the euro area's public finances. The new fiscal compact and the six-pack partly improve this problem (Herzog, 2012b). It is insufficient, however, to only establish such an economic governance framework. The key is not its design and establishment but an automatic or independent enforcement of the rules.

4 Some argue that labour mobility does the job in a monetary union with fixed nominal exchange rates. Empirical evidence suggests, however, that this is only true in the long run (Puhani, 2001). Moreover, labour mobility is far too low to smooth the huge imbalances in the euro area (De Grauwe and Vanhaverbeke, 1993).

The lack of enforcement of rules

As has been discussed, the Achilles heel of the Stability and Growth Pact is its weak enforcement of inadequate provisions, together with a non-existent pre-emptive function. The lack of political willingness to enforce those rules that do exist and the absence of incentives discourages compliance (ECB, 2008).

Firstly, the initiation of the pact's procedure always needed the backing of the Commissioners before any procedural steps could be taken. Secondly, a qualified majority was then required in the ECOFIN Council in order to approve further steps. Euro zone member states that 'sinned' retained the right to vote and needed only a few other countries to block the decision-making process of the Stability and Growth Pact. As long as both sound and unsound countries are part of the ECOFIN Council and are able to decide fiscal policy measures together, EMU's economic governance is doomed to fail. From a rational perspective it would not make sense for a financially unsound country to encourage the punishment of member states breaching the 3 per cent deficit limit if it could be the next one violating the threshold. This is a constructional defect of the decision-making rule and it prevents a credible enforcement of the regulations. When Germany and France, among others, breached the deficit threshold in 2003 and 2004, the ECOFIN Council could not even agree on sending a blue letter (i.e. an early warning) to these countries to remind them of their duties.

The current enforcement mechanism ensures that member states do not internalise the potential costs of deficit and debt accumulation caused by their own policies. This is a well-known problem from the experience of historical monetary unions. Bordo and Lonung (1999) conclude that the cause of the collapse of past monetary unions – such as the Latin Monetary Union from 1914 to 1927 and the Scandinavian monetary union from 1914 to 1924 – was mainly driven by political developments and bad institutional rules. In both cases the dissolution was determined by fiscal policy problems as a consequence of high debt accumulation during World War I. To tackle the root of the problem, we have to go back to a decision-making mechanism that is independent of the offending countries when there are policy failures in those countries. In 1995, the founding father of the Stability and Growth Pact, the former German finance minister Dr Theo Waigel, proposed a completely automatic sanction procedure. At that point in time it was too far-reaching from a political point of view. Today we argue that the time has come for a temporary sovereignty loss in case of sustained violation of the rules to which euro members commit themselves.

The lack of enforcement of rules, of course, causes a compliance problem. Since the onset of EMU, there have been more than sixty breaches of the SGP but none triggered any consequences. Even the first litmus test of a rigorous implementation of the Stability and Growth Pact failed. In autumn 2003, France and Germany, among others, blocked the strict implementation of the pact by colluding in order to reject the Commission's recommendation to move a step further in the sanction procedure. Indeed, the EU Commission was forced by the policymakers in 2005 to propose a reform which would introduce yet greater discretion, leniency, flexibility and political influence into the procedure. A second famous example is the treatment of Greece. Since 2000, Greece has had an annual deficit above 3 per cent of GDP according to ECB data. The first excessive deficit procedure was launched in 2004, however, when the government deficit was 7.9 per cent of GDP.[5] In 2007, the European Commission closed the procedure because they forecast a deficit of 2.9 per cent of GDP, though this turned out to be 6.8 per cent. The debt level in 2007 was forecast to be 97.5 per cent of GDP (it turned out to be 107.4 per cent), well above the reference value of 60 per cent of GDP. Both the EU Commission and the ECOFIN Council failed owing to time lags, misreporting and political unwillingness. Hellwig (2011: 3)

5 Some critics argue that the Stability Pact is pro-cyclical and rigid. This is absolutely wrong because the idea of the pact is to provide a pre-emptive mechanism before it leads to procyclicality. The weak enforcement counteracted this idea, however, and led to pro-cyclical effects in the end. Moreover, if countries act in accordance with the pact and adjust the budget close to balance in good times, they have had no or almost no problems with the 3 per cent deficit limit in bad times, as Luxembourg, Estonia or Germany illustrate.

correctly concluded: 'The lack of credibility of the Stability and Growth Pact was identified as a problem [long before]. Therefore it seemed likely that at some point over the medium run, we would come across a problem like the one that Greece has posed over the last year.' Since the SGP reform discussion in 2005, economists have proposed more than a hundred improved alternatives (Fisher et al., 2006). There was still no political will for reform, however.

The phenomenon of non-compliance is a well-known general problem. A few years back Inman (1996) provided an analysis of this problem for the US states. He suggests that, once a rule is established, a mechanism is needed to ensure compliance. Even the new EMU rules, however, developed post-crisis, are insufficient to establish a sound framework with a high level of compliance. In particular, there is closed and partisan enforcement.

More positively, policymakers in some countries have agreed to complement the economic governance framework with constitutional debt rules. Even this will not be effective, however, because there are no links between these new national and supranational rules and there are no incentives to internalise the costs of domestic policies. An example of the former problem is constitutional debt rules that have been adopted in Spain. While welcome, they have been developed in Spain to deal with credibility problems mainly within the Spanish political system itself. If Spain decided to change those rules, it could do so because they do not relate to the supranational system of governance of the euro zone. Again, rules do exist but, because they do not emanate from the EMU institutions, they cannot be enforced by those institutions.

Moreover, European institutions do not analyse and take action over current account imbalances or inflation and growth differentials within the currency union. This is illustrated by the problems that arose in the financial crisis. Financial markets are international but their regulation is still national. It is said that 'banks are international in life, but national in death' (Goodhart, 2009). But this is definitely not true in a monetary union, nor perhaps more generally in an interconnected world. In the case of Ireland, we have learned that the costs of bank bailouts are not just born by Irish taxpayers, but by all European taxpayers – especially those in countries participating in EMU. This illustrates the need for a European rule-based framework in terms of economic and financial regulation and supervision.

Furthermore, the lack of nominal exchange rate movements has destroyed the international competitiveness of important industries in some EU countries. Usually the loss of competitiveness affects the nominal exchange rate but, in a monetary union with irrevocable fixed nominal exchange rates, that mechanism does not work. Eichengreen and Hausmann (1999) have shown that, when lenders distrust governments and refuse to lend in a given country's currency, it will devalue. This would have happened to Greece and Portugal if they had retained their own currency. Indeed, given their lack of fiscal discipline, they would have struggled to borrow in their own currencies in the first place. In the improper EMU framework, markets have learned quickly how to game the rules by lending to governments with inappropriate fiscal policies, knowing that their debts are implicitly guaranteed by others.

Now it's time to learn the lessons and adapt the unsuitable strategy in the euro zone. The almost non-existent economic governance in the past ten years and the recent rescue programmes have taken EMU on the wrong path. This has put all national governments and the EMU at risk. To resolve the current crisis, we have to look for smart solutions and innovative institutional rules which are enforced *ex post* and known to be enforceable *ex ante*. Economically, I would argue that the euro will be beneficial and necessary to tackle the challenges in a world of freer trade and capital movements and in an ageing society (Mongelli, 2008; European Commission, 2011). However, to maintain this monetary union, policymakers must design credible and enforceable rules.

Enforcing enforceable rules

The European Union's policymakers are still far from finding the right way out of the sovereign debt crisis towards a long-run sustainable monetary union. But there is a solution and, after implementing the new rules, the EMU will no longer be endangered.

In this section we will make proposals that will lead to stability within EMU. There are two options. Neither option works, however, without re-establishing and enhancing the credibility of the existing framework. *Option A* (hierarchy) is a fundamental change to the existing policy framework. This option would insist that EMU member states abandon a substantial part of their national sovereignty over fiscal policy. This would require immediate and fundamental legal changes at the European and national levels. The judgment by the constitutional court in Germany has partly eliminated this option for the near future (Bundesverfassungsgericht, 2011). Of course, there is an ongoing delegation of fiscal competences; the key fiscal responsibilities, however, remain on the national level, and they are even being strengthened in the domestic context. For instance, the German constitutional court has also strengthened the rights and veto power of the German parliament significantly (Bundesverfassungsgericht, 2012). Since *Option A* is complex and lacks 'real' political interest as well as support, a European state is currently not a realistic option.

Option B (decentralisation) and an effective rule-based framework aligned with market forces and consistent institutional incentives is more realistic. This will strengthen the fiscal incentives to maintain sound finances within the current framework. *Option B* requires a return to and an enhancement of the fundamental principles of a monetary union. Obviously it is also a 'more European' option (Salines et al., 2011). The following list summarises crucial elements:

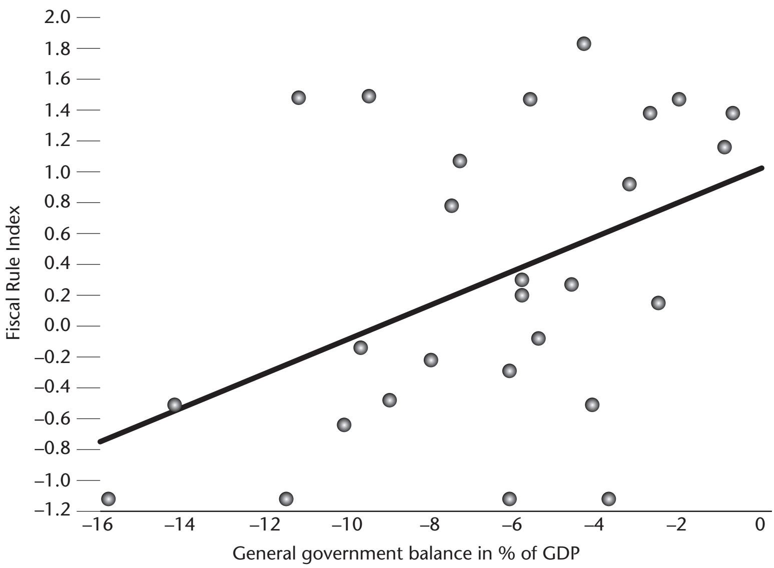
- Each member state has to bear the consequences of its own fiscal policy decisions.
- Market interest rates have to serve as a disciplining mechanism in the case of unsound debt policy.
- Pre-emptive and automatic enforcement mechanisms have to support compliance with rules.

- Mechanisms have to smooth differentials between growth rates, inflation rates and current account balances.
- *Ultima ratio* punishment options have to handle notoriously unsound countries.

The key philosophy of *Option B* is that countries bear full responsibility for their own policy actions in combination with a rule-based framework. Consequently, we have to go back to a strict no-bailout clause in Article 125 of the Treaty on the Functioning of the European Union (TFEU). In the same vein, the European Central Bank (ECB) must go back to its primary objective of price stability and must abide by the prohibition of monetary financing (Articles 105 and 123, TFEU). In addition, *Option B* requires a full rethinking and establishment of a supranational economic governance mechanism which is able to tackle the divergence of current accounts and macroeconomic differentials in the euro zone. Undeniably, this mechanism has to be backed by market forces and incentives. The precise make-up of such a toolbox is an issue for further research. We have in mind, however, the use of target functions that are already well known in monetary policy and their application to fiscal and economic policy issues with a solid democratic backing. These target functions define certain target levels and any deviation from targets will almost automatically lead to adjustments.

Such a rule-based framework together with pressure from financial markets would lead to the pre-emptive disciplining of unsound fiscal and economic policy. Pre-emptive warning mechanisms and well-designed fiscal rules are an essential ingredient of successful consolidation according to Holm-Hadulla et al. (2011). In addition, a recent empirical study on the euro area by Escolano et al. (2012) finds that fiscal decentralisation and strict fiscal rules on the supranational and federal level have been associated with better fiscal performance. The basic idea behind these proposals is that the current rule-based approach is not dead (Issing, 2011; Weidmann, 2011) but that weak enforcement, the lack of pre-emptive incentives to encourage sound

Figure 16 **Fiscal Rule Index* and deficit performance, 2009**



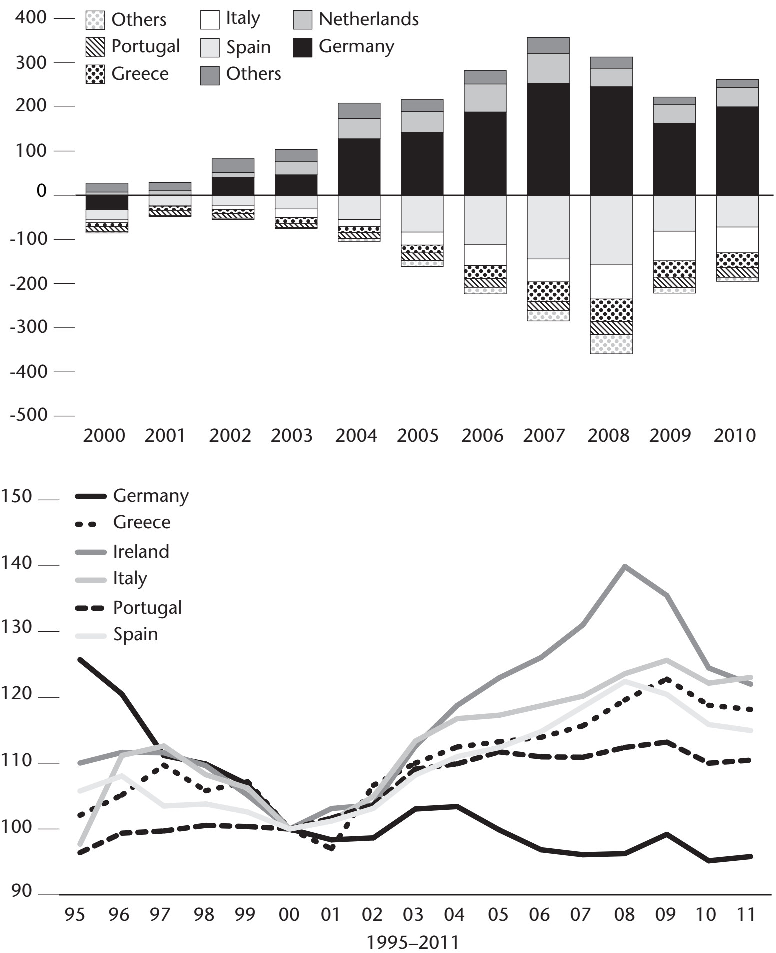
*The Fiscal Rule Index (FRI) is provided by the EU Commission. Its calculation is based on the countries' information on (i) the statutory base of the rule; (ii) room for setting or revising its objectives; (iii) the body in charge of monitoring respect for and enforcement of the rule; (iv) the enforcement mechanisms relating to the rule; and (v) the media visibility of the rule.
Sources: Eurostat, EU Commission, own calculations

public finances and the political discretion in EMU's economic governance are the problems.

A bivariate regression of public deficits and the strictness of fiscal rules of individual countries show how better fiscal rules are related to lower deficits in the EU (Figure 16). The relationship is robust despite the low R-square which is due to the exclusion of major macroeconomic variables, such as taxes, expenditures, debt levels and the business cycle position.

Apart from the institutional weaknesses the potential for macroeconomic divergence was not taken into account in the existing economic governance framework. The dramatic divergence between unit labour

Figure 17 **EMU's current account imbalances (top, € billion) and divergence in unit labour costs (bottom, index)**



Sources: ECB

costs and current account imbalances is just one issue. Figure 17 shows that no mechanism or warning sign has appeared that was acted upon by the ECB despite the evident divergence. We therefore need new mechanisms that internalise the costs of such macroeconomic differentials within the euro zone.

Because there is no permanent loss of sovereignty in *Option B*, a consistent rule-based agenda combined with market forces is necessary to provide discipline. The timing of the reform steps and policy changes is critical for regaining stability within EMU. The ways in which economic governance must be strengthened and extended in several dimensions are outlined below.

Proposal 1: Define ex ante *conditionalities for all EMU member states*

The major underlying policy problem of the rescue packages during the sovereign debt financial crises is moral hazard. To tackle this problem we need consistent incentives towards sound public finances. Therefore, we propose an irrevocable return to the initial incentive structure without exceptions. In order to be a member of EMU, the country must fulfil all stated criteria at the beginning and regularly thereafter. We call this '*ex ante* conditionalities'. These are mandatory conditions for all participating countries made up of (1) sound public finances (i.e. a balanced budget in the medium term), (2) a conservative wage policy and (3) continued economic reforms to enhance growth and competitiveness. In the end, we propose a far more comprehensive and exclusive rule-based framework. A violation of any of these criteria will immediately be identified and/or corrected or sanctioned – similar to mechanisms proposed in relation to austerity packages today.

The current approach leads to tough austerity conditionalities for highly indebted countries after the crisis. This is too late. From the beginning, each country has benefited from EMU without following the necessary rules. Therefore, the existing governance framework sets the wrong incentive at the wrong time. We must make the conditionality of EMU membership *ex ante* and permanent. This strict and irrevocable condition will be effective and reduce pro-cyclicality. Successful budget consolidation has to start in economically good times and requires credible institutional incentives. For the sanctions to be credible, however, EMU cannot be a one-way street. Membership of EMU requires continual fiscal discipline. If a country fails to perform, it will be punished as discussed in the further proposals below.

Proposal 2: Reform the Stability and Growth Pact

The Stability and Growth Pact needs to be reformed in the following way:

1. By introducing immediate sanctions if the deficit threshold, the debt threshold or the goal of a balanced budget in the medium term is violated.
2. By improving the enforcement either with an automatic or a vote-and-reputation mechanism.

These objectives can be reached by introducing an independent fiscal council or an (almost) automatic enforcement mechanism. An independent fiscal council should be structured in a way similar to the Swedish Fiscal Policy Council (Calmfors, 2010) or the German Council of Economic Experts, according to a proposal by the ECB (2010). The council consists of five or more independent members who are academics who possess expert knowledge in economics and public finance. Alternatively, if there is no agreement to an independent fiscal council, we suggest an automatic enforcement or an 'intelligent voting mechanism' within the Stability and Growth Pact. This voting mechanism involves the loss of voting power in the excessive deficit procedure for all countries with deficits above 3 per cent of national income. This is an immediate and explicit sanction for unsound members of the euro area. Casella (2001) and Herzog (2004b, 2004c) developed such vote-and-reputation mechanisms. The mechanism mainly depends on three factors: the target gap between the excessive deficit and the 3 per cent deficit limit; the frequency of violations; and the time horizon to achieve the balanced budget. These three determinants trigger a gradual reduction in the voting rights of the member states in the ECOFIN Council. In case of sustained policy violation the mechanism leads to a full loss of sovereignty. Such an intrinsic punishment in terms of loss of sovereignty is preferable to the current extrinsic incentives of monetary sanctions (Herzog, 2004a). It is the only mechanism that can establish a smart way for countries to internalise the costs of their policy decisions without centralising fiscal power. Only countries that are behaving in line with the founding principles of the euro will have full sovereignty and voting power, whereas those which are not – and which are imposing costs on others owing to their fiscal profligacy – will lose voting power. Economically, one could see such a vote-and-reputation mechanism as an insurance premium for the sound countries. An automatic mechanism is quite similar to a vote-and-reputation function. The latter is more effective, however, because there is no discretion. From a political point of view, the vote-and-reputation function is therefore the most realistic and effective option in the near future.

The EMU's rule-based framework will not work as long as the policymakers, whose job it is to enforce the rules, are motivated by economic and political incentives to neglect to do so. A transparent incentive system will enhance the credibility of economic governance in the future because every country will know in advance that a violation triggers a significant loss of sovereignty.

Proposal 3: Introduce enforcement measures leading to a loss of sovereignty or a principle of exclusion in the case of unsound fiscal policy

Owing to the specific constellation of fiscal–monetary interaction and the emergency programmes of the European Financial Stability Facility and later on the European Stability Mechanism other incentives towards sound fiscal policy are needed. Firstly, we recommend a strictly enforceable and more credible no-bailout clause in line with Article 125 of the EU

Treaty. This includes that the ECB must follow its legal mandate of price stability (Article 105, EU Treaty) and reject implicit monetary financing (Aliber, 2012). The acceptance of collateral bonds for open market operations by the ECB should depend on the ECB's independent assessment of the sustainability of countries' public finances in order to achieve the target of price stability. This assessment might range from limited access to repo operations through the use of substantial haircuts through to the refusal of government bonds issued by notoriously unsound countries that breach the pact. Of course, the new fiscal and economic rules cannot avoid unforeseen shocks or banking crises, which is why we need emergency measures. Both monetary and fiscal policy, however, should act independently of each other within this mandate. Secondly, the European Stability Mechanism should only be allowed to serve as lender of last resort for member states in very special cases and with even stricter austerity conditions which avoid an enduring interest rate subsidy. In other words, we need to return to realistic market interest rates that reflect the idiosyncratic risks – including credit risks – of euro-denominated bonds.

In addition, we propose that the European Stability Mechanism should focus on countries in trouble owing to massive exogenous shocks, unforeseen and significant market reversals or catastrophes. It should be a temporary mechanism and not a bailout fund for inherently unsound governments. Countries with unsustainable public budgets or countries which have not complied with the fiscal rules for several years should have access only if they give up their full sovereignty. Also, to sustain the long-run stability of the monetary union, we propose an *ultima ratio* sanction for unsound states. Countries violating fiscal rules for more than three or four years in a row would then lose full fiscal sovereignty and could continue use of the euro only with no participation in its governance mechanisms. Alternatively, they would have to leave EMU. After fulfilling the *ex ante* conditionalities, the country would either regain national sovereignty, or, in case of exclusion, be given the option to rejoin the governance mechanisms of EMU under certain defined conditions.

Proposal 4: Democratise European Union economic governance

The new rules and institutions for fiscal policy must serve the purpose of democratising European economic governance. Those means will serve each national citizen best by maintaining a national policy system and integrating supranational coordination only in special cases. If a country fails to consolidate the public budget, however, or to enhance domestic competitiveness, the supranational level should take more and more responsibility for this specific country. In normal times, we recommend an environment in which fiscal policy is applied effectively at the national level to promote national needs (Oates, 1972, 1999). That way it will enhance the welfare of domestic and neighbouring countries most effectively. It is important that fiscally sound countries can decide about the use of their taxpayers' money and the new rules and principles must serve the purpose of European citizens by making our institutions more democratic.

The old rule-based framework was not complete, consistent or credible. Thus, an effective economic governance agenda will offer the opportunity to be successful in the long run. As with a football match, only with an effective referee can the best players show their real talent. Well-designed and enforced rules prevent countries from 'playing rough' and unfairly and support fair play by those countries which abide by the rules that are necessary for monetary union to work.

Conclusion

European Monetary Union will not fail and the integration process will not be reversed if policymakers return to credible, strict, consistent and enforceable rules. Our proposed mechanism will create a well-founded EMU in the long run. Moreover, policymakers have to learn that fiscal policy in a monetary union requires continual hard work.

First and foremost we have to remove the arbitrariness of fiscal rules and economic governance. Together with the democratisation of European economic governance we would propose a more stable and sustainable EMU. The lesson from the crisis is not that the EU should become a political union but that stable and enforceable rules should be developed and that these rules need to be enforced in better economic times.

The euro zone needs to refine, extend and enhance existing rules as well as complement these rules and institutions with better enforcement procedures, pre-emptive incentives and intelligent sanctions. Of course, an effective economic governance framework restricts the room for manoeuvre, but market forces also do the same in the sense that those taking economic decisions have to bear the consequences of those decisions rather than impose the consequences on others. Such an enforceable rules framework is the price that needs to be paid for the benefits of a currency union. We must design the rules in such a way that they serve the people best and promote long-term growth.

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