BREXIT AND THE EURO CRISIS: WHAT KIND OF UNION DO WE WANT?

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Abstract

The article deals with the two key issues that have been fundamentally changing the European Union – the crisis of Eurozone and the Brexit. The first part discusses the change of the original balance of power in the EU after the exit of Britain and its possible consequences, especially the strengthening of the relative position of France, and hence the French concept of the EU integration model (deeper federalization of the nucleus and the rest) resulting in an even more explicit model of the two-speed EU. In the ideal Pareto model of the Union, paradoxically, the possibility of exit makes the Union more stable and compact. The second part of the text discusses the problem of the uncompetitiveness of Southern Europe as a specific case of Dutch Disease and four scenarios of its solution – the disinflation or deflation of the South, the inflation of the North, the exit from the common currency and finally the transfer union. The last named scenario is the least attractive of given options, but it is already in progress. The imbalances in the Target 2 payment system discussed in the article are example of this. The conclusion of the article brings ten points summarizing necessary economic and political measures for the EU at the time of power shift after the Brexit and ongoing imbalances between the North and the South in the currency union.

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Souhrn

Brexit a krize eura: jakou chceme Evropskou unii?

Text se vyrovnává s dvěma klíčovými událostmi, které zásadně mění Evropskou unii – s pokračující krizí eurozóny a brexitem. První část diskutuje změnu původní rovnováhy moci v EU po vystoupení Velké Británie a její konsekvence. Jedním z hlavních důsledků je posílení relativní pozice Francie, a tím i francouzské představy o podobě evropského integračního modelu (federalizační francouzské jádro a zbytek), která by vyústila v ještě explicitnější model dvourychlostní Unie. Dílčí závěr tvrdí, že v ideálním paretovském modelu Unie je možnost exitu paradoxně tím, co drží Unii stabilní a kompaktní. Ve druhé části textu je pak diskutován problém nekonkurenceschopnosti

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jihu eurozóny jako specifického případu holandské nemoci a jsou nastíněny čtyři scénáře jejího řešení – desinflace či deflace jihu, inflace severu, opuštění společné měny nebo transferová unie. Poslední jmenovaný scénář je tím nejméně efektivním, ale zároveň v současnosti již probíhá, a to i prostřednictvím platebního systému Target 2. Závěr článku přináší v deseti bodech souhrn ekonomicko-politických opatření pro EU v proměněných mocenských podmínkách po brexitu a v čase pokračujících nerovnováh mezi severem a jihem eurozóny.

Introduction

The current euro crisis together with the British exit from the EU means crucial systemic changes for Europe, the European Union and its functioning. In view of these changes, the possible scenarios of future development need to be discussed. In this article I will discuss the options for further European integration taking a critical view of the proposals coming both from Brussels and France.[1]

Europe is shocked now that the seemingly impossible has happened. After a surprising referendum in June 2016, Britain is now preparing for exiting the European Union. The clock for the two-year period of negotiations for countries leaving the EU started ticking in March 2017.

The decision of the United Kingdom to leave is a vote of non-confidence in the EU. For too long there had been concern with the power grabbing of Brussels institutions, which abused the subsidiarity principle and tried to meddle in everything through European Council decisions: the quality of drinking water, the shape of cucumbers, the minimum length of bananas, the colour of apples, the power of vacuum cleaners, the energy consumption of dishwashers, the local NOx pollution stemming from cars, how a country must construct the floors in gyms and so forth – all areas where there are no border-crossing externalities, which could justify central intervention. Moreover, patience had run out with the interest-based rulings of the European Court of Justice, which tried to place itself above the national supreme courts, an issue that has irritated the Brits, the Czechs and many others (Klaus, 2009).

Above all, there was reluctance to accept the rules governing the immigration of EU citizens. Prime Minister Cameron's attempt to reduce the magnetic attraction of the British welfare provisions for immigrants by delaying integration into the social security system was refused with a frosty smile by the EU elites. This humiliation strengthened the Brexit fraction immeasurably.

Brexit is a major crisis for the EU because the United Kingdom is so large. It is not just any EU country, but the second biggest economy in the EU. The economic strength of the United Kingdom is as big as that of the 20 smallest countries put together. It is as if 20 of 28 countries were leaving at the same time.

1 While this article was written and given as a lecture originally before the French election, I took it for granted that Macron would win and commented on his proposals. The written version of the article was, however, prepared *ex post*.

This fact alone shows that nothing in the EU will now stay the same. The Brits have voiced much justified criticism of the EU institutions and its rules. This criticism should be taken seriously and heeded through fundamental reforms of the EU. Such reforms need to address the eligibility of benefits to migrants, address the magnet effect of Europe's welfare states, as well as develop a new framework for the euro. The difference between inherited and earned welfare entitlements, the introduction of voting rights reflecting liabilities in the European Central Bank Council, the settlement of Target-2 balances following the US example, bankruptcy rules for states, rules for an orderly exit from the euro and the resulting depreciation of national currencies and many more issues need to be discussed.

1. A Destroyed Balance of Power

For exporting countries like Germany, Austria and the Czech Republic, which are linked closely together in value chains that ultimately enable German exports, Brexit is devastating. The United Kingdom is Germany's third biggest and the Czech Republic's fourth-biggest export market. At a time when President Trump threatens exports to the US, which are the most important of all, the risk of also damaging another big export market is anything but trivial.

The UK is also one of two countries in the EU with nuclear weapons. France, the other remaining country with nuclear deterrents, will dramatically increase its political weight in the EU. The result is a one-sided dependency for Germany and a destroyed balance. This comes at a sensitive time with criticism of the NATO voiced by the new US administration. The members of the German Bundestag knew what they were doing when they adopted in 1963 a preamble to the Elysée Treaty which stated Germany's hope to include the United Kingdom in the European partnership, very much contrary to the wishes of President De Gaulle. It took three attempts, after De Gaulle blocked approaches in 1963 and 1967, before the Brits were able to join the European Community in 1973, after De Gaulle's death.

The destroyed balance renders futile the minority rights in the European Council, as specified in the Lisbon Treaty, which were due to fully come into force after a transition period on 1 April 2017. Most European Council decisions require 55% of countries and 65% of represented population, which means that countries that combine 35% of the EU population have an effective blocking minority. Together with the United Kingdom, the so-called former "deutschmark bloc" (Germany, the Netherlands, Austria and Finland) has a population of 35%, exactly what is needed for a blocking minority. These are all countries that favour free trade. At the same time, the EU countries surrounding the Mediterranean, which have traditionally been more reliant on state intervention, have a population of 38%, also a blocking minority (Sinn, 2017). This balance, which was aimed for by the Lisbon Treaty, has now been destroyed because the first bloc shrinks after Brexit to a population share of 25% and the Mediterranean countries extend theirs to 43%, significantly more than what is required for a blocking minority. These countries can and will now extend their power to turn Europe into a trade fortress. It is true that a few other countries can also be considered pro-trade, among them the Czech Republic, but there are also a number of countries that can be suspected to prefer protectionist policies.

It is not surprising that the new French President, Emmanuel Macron, has already campaigned for a European protectionist response to Donald Trump's threats, urging Europeans to buy their own goods. Such policies reflect French traditions. The losers from US-French trade attitudes will include countries like Germany or the Czech Republic because they are strong in manufacturing and need world-wide trade to be profitable.

The erosion of minority rights requires new negotiations of the existing EU contracts, if not a German notice of termination pending a change of contract. This new negotiation will not be feasible once the negotiations with the United Kingdom have been completed but should start as and when the exit discussions with the United Kingdom commence. They have to be integrated into an overall package which determines both the internal relationships within the EU and the relationship between the remaining EU and the United Kingdom. Iron can only be shaped when it is hot. Once the United Kingdom has left, there is no chance for Germany to achieve a long-term sustainable structure of decision making.

1.1 Again a Two-Speed Europe?

But how should the new Europe look? The EU Commission, Emmanuel Macron and, more hesitantly, Angela Merkel are promoting a two-speed Europe. Basically Macron wants to give the Eurozone a more state-like structure and leave the non-euro EU countries out, given that they are reluctant to follow this approach.

In a sense, this had been the position thus far, reflected in the euro and the Schengen Agreement. It has fundamentally divided Europe. Pursuing it further will, following the United Kingdom, aggravate Poland as well as Denmark, Sweden, the Czech Republic and Hungary. Whoever wants to respond to Brexit by giving the Eurozone more state-like structures separates the North and East from the West including Germany and the South, draws a dividing line through Central Europe and makes Germany an appendage and paymaster general of a new Latin currency union.

The President of the EU Council and Polish politician Donald Tusk has argued that there already was a two-speed Europe until Communism collapsed in 1989, and he warned repeating the mistake.

The fact that France wants this two-speed approach is not surprising. The division of Central Europe has been a central tenet of French policies ever since Richelieu. Although he was a Roman Catholic cardinal, Richelieu supported the protestant Swedish and Czech forces, which seemed to be losing ground in the battle with the Catholic forces. With success, as we know. He extended the duration of the war to 30 years and opened the path for French hegemony in Europe (Kissinger, 1994).

The new president Emanuel Macron offers a programme, which will spare the French deprivations seeking instead German approval for a Eurozone budget with Eurozone taxes and Eurobonds, a mutual deposit insurance scheme and common unemployment

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insurance. This policy will undermine the EU because it will give the Eurozone, which is just a subset of the EU, a state-like structure with a separate parliament, its own taxation capacity and a separate finance minister. Germany may hesitate, because it fears being forced to agree to systematic and permanent transfers to France's clients in the south of Europe, hence indirectly supporting the French economy. However, in the end it may agree, if only because it fears that if Marcron is not successful, Marine Le Pen will be elected next time around.

1.2 Why the EU Should Be Generous to the Brits?

Instead of going along with France towards a further deepening of the split of the EU and a policy of punishing the United Kingdom, Germany would be well advised to adopt the position of mediator in the Brexit negotiations. Ultimately, these negotiations should heed the British wish to allow free trade despite restrictions to free movement. Free trade is not a gift to the British, but mutually beneficial for all associated countries.

The disadvantages of limiting free trade are particularly strong when labour cannot move. EU officials have implicitly denied this by arguing that the British should not be allowed to cherry pick. Free trade can only be granted in conjunction with free movement of people, they maintain. But this is economic nonsense because, especially when labour cannot move, it is essential that at least goods and capita can move freely. Without free movement of people, the differences in wages between countries remain greater and the higher these differences, the larger the differences in goods prices between countries, which in itself is the fundamental source of gains from trade. It is like having two hands that can act as substitutes. If one hand is handicapped, the free mobility of the other one is even more important.

In addition to securing these economic gains, it cannot be in the general interest to punish the United Kingdom because this would take the net-payers' exit options and make them subject to blackmail. I do not want to be misunderstood here. For me the EU is a beneficial development in European history which has brought the Continent peace and prosperity. Thus Germany, the Czech Republic as well as all the other EU countries should make intense efforts to keep everything together. However, the exit option is always a warning to those who want to redistribute resources not to overdo things.

1.3 Two Models of a Federation

There are two models for a federation. The first model is characterised by strong minority rights and voluntary cooperation. It is based on the Pareto Principle which is the fundamental efficiency criterion in economics. Decisions have to be beneficial for at least some member states and not to do any harm to any others, thereby increasing the "cake" for all. The Pareto model is stable because everybody wants to be part of it. The second model is based on majority decisions without strong minority protection. In this model, decisions that benefit a majority but harm a minority will be taken even if the majority gains less than the minority loses, thereby reducing the "cake". This model generates losers who would rather leave and is therefore inherently unstable. To prevent exits there is a need for punishment, but the fear of punishment itself implies mistrust and strife (Sinn, 2017).

As paradoxically as it may sound, to maintain a stable union without mutual exploitation, in which everyone participates happily and voluntarily, it is imperative to make exits easy. Easy exit options will ensure that the union only makes mutually beneficial decisions which will make everyone eager to maintain the privilege of club membership. This should be a guideline for the negotiations with the United Kingdom.

That being said, it should be stressed that a firmer union is conceivable in the sense of having a mutual insurance contract giving those who have had bad luck the right to demand support from the lucky. Such a contract, as voluntary as it might be from an *ex-ante* perspective, needs force to be implemented *ex post*, as the lucky might otherwise wish to negate the contract although they found it beneficial before they knew how the dice of history would be cast. In the case at hand, such an insurance contract would be equivalent to the creation of a political union with a common state that has the necessary power to implement the payments and prevent the lucky from exiting.

However, a common state first and foremost means a common power centre with a common army. While I can imagine that Germany and perhaps Poland would be willing to go that far, if the economic conditions in the South had normalized such that a fair mutual insurance contract could be envisaged, I doubt that France would ever be willing to sign on to such a contract. I instead expect that they will try to keep their nuclear submarine force, the Force de Frappe, for themselves and would not agree to subject it to the control of a European command. I may be wrong though, and Macron could be the big unifier of Europe who gives up the French privilege. In that case, he might succeed in getting some of his other wishes fulfilled.

The union that Macron will try to erect in close cooperation with France's allies in Italy, Greece, Belgium, Luxembourg and other countries, is a transfer union rather than one that resembles a fair mutual insurance contract within a political union. The transfer union cannot be equated with insurance, as the dice are already cast. The South is in trouble, and it is not conceivable for the time being that it will regain its competitiveness within the Eurozone. I am afraid that Macron may simply want to organize regular payments from the North to the South *via* the channels mentioned above, *i.e.* a common Eurozone budget, common unemployment insurance and common deposit insurance and jointly guaranteed debt instruments, without giving the EU access to France's nuclear forces. The fresh money he wants to carry to the South of Europe will serve as Keynesian opium that makes everyone feel good for a while. The good period may be enough for his presidency, but it will not be sustainable to the contrary.

2. The Dutch Disease

For one, the public money coming from other countries will drive large parts of Europe into a Dutch disease. The Dutch disease happened in the 1960s when the Netherlands had found a giant natural gas field in their territory. The sales of the gas led to a revaluation of the guilder and allowed the energy industry as well as the government that received more taxes from it to increase wages, which then forced other sectors to follow suit. Both effects undermined the competitiveness of the Dutch manufacturing sector. It recovered only in the 1980s after the gas price had come down together with the oil price, to which it was attached, and the gas resources petered out.

Transfers and credit operate in exactly the same way as the proceeds from selling the gas. It sustains a living standard that is not covered by the productivity of the manufacturing sector and deprives the Southern countries of their competitiveness. They will all be in a similar situation as the Netherlands in the 1970s and the Italian Mezzogiorno or the formerly communist new German Lander today. There will not be enough jobs for the young, but the living standards of the pensioners and government employees will be large enough to keep the internal, non-trading goods sectors alive. The countries become drug addicted.

2.1 Repeating the Mistakes in the Early History of the United States

For another, debt mutualisation will imply excessive borrowing because it drives down the interest spreads and blocks the automatic brake that normally slows down the speed of debt accumulation by increasing the interest rates for countries that drive the debt road too fast. The blocking of the interest brake could be fatal.

The prominent example of this effect stems from the early history of the United States of America. After its foundation, the first Secretary of the Treasury, Alexander Hamilton, mutualised the debt of the single states arguing that the mutualisation would be cement for the newly created federation. There was another round of mutualisation in 1813 during the second war with Britain. After the mutualisation rounds the states believed that this could go on. Borrowing would bring them money they could spend, while the debt services would be shifted to the federal level. They borrowed to build roads, public buildings, canals and other types of infrastructure. This created a strong Keynesian demand boom that boosted the economy, but also led to a mentality of squandering the money. While everyone was happy initially, the boom turned into a bubble that burst in 1837. From 1837 to 1842 nine out of 29 American states and territories formally declared bankruptcy, and the still solvent states, which were supposed to help out, were handicapped enough not to be able to rescue anyone. Nothing but hassle and strife was the result of debt mutualisation. British American historian Harold James of Princeton University argues that the debt mutualisation was not cement as Alexander Hamilton thought but an explosive (James, 2012). He drew a direct line from 1842 to 1861 when the war of Secession started. Of course that war broke out primarily because of the slavery problem. However, the unresolved debt problem contributed to the tensions that caused the war. Only after the Civil War did the Americans find the roles that have prevailed until today and that have given their federation stability and prosperity. If a state goes bankrupt, its creditors have to bear the consequences. They instead of the taxpayers from other states must bear the losses. This is in fact a self-evident liability rule for any viable federation. Only if the creditors know that excessive lending might imply that they might not get their money back will they stop lending too much or charge high interest rates, which would induce the borrowers to stop living beyond their means. Only then can bubbles be avoided.

California recently had troubles. The state was unable to pay its teachers in the summer, and it issued IOUs, a sort of partially transferable debenture, which served as a sort of Californian money. Minnesota and Illinois also were close to bankruptcy. But there was not money coming from other states or the federal government to help out, let alone guarantees that would calm the creditors. Neither did the Fed buy the government bonds of these states, unlike the ECB, which has bought huge amounts of government bonds from crisis-inflicted Eurozone countries and has promised to do so in an unlimited way if necessary with its OMT programme ("whatever it takes") (Sinn, 2016a).

Similarly rigid rules prevail in Switzerland. Each Swiss canton is fully responsible for its own actions. If the borrowing canton cannot repay its creditors, the creditors have to accept the losses as no other cantons of the federation will come to the rescue. This no-bailout rule has provided stability to the Swiss federation up to this day.

It is true that the new French President Emmanuel Macron does not propose to mutualize the existing debt of the European countries. However, he wants them to borrow jointly for a federal budget, and it seems that he has not excluded his earlier ideas of introducing Eurobonds for new government debt.

2.2 The Nature of the Southern Disease

The bubble the US experienced because of debt mutualisation reminds us of the bubble the euro created in Southern Europe after it was firmly announced at the Madrid Summit of 1995. The announcement induced a rapid reduction of interest spreads relative to Germany for Southern Europe. They all had to pay high interest rates because investors were afraid that the currency, in which the bonds were denominated, would lose its value at the time of repayment. But this risk diminished as the time of irrevocably fixing the exchange rates, May 1998, approached. Italy, Spain and Portugal experienced a fall in interest rates by about five percentage points. The Italian state saved so much money on interest payments that it could have abolished its value-added tax in exchange. This was like an outright fiscal transfer from the community of states, because it implicitly offered the investors insurance without charging them a premium. After introducing the euro, it simply was considered improbable that countries having access to local euro printing presses would run out of cash so that they would be unable to repay their loans. The reduced interest rates made it very attractive for the states to borrow. In Greece the state borrowed to employ more people in the government sector and to increase the wages of the government's existing employees. In Spain people borrowed from their banks to buy real estate, and the banks in turn borrowed abroad in the interbank market. The housing investment created a boom and eventually a bubble, during which wages of construction workers increased enormously forcing the wages in the rest of the economy to grow faster than the increase in productivity. The excessive wage increases in turn forced goods prices to go up relative to the rest of the Eurozone. This deprived the economy of its competitiveness. Small wonder that the output of the Spanish manufacturing sector even today is a quarter below the level it had obtained ten years ago, before the crisis broke out. This is the problem of Southern Europe as such. The economies are simply too expensive relative to Northern ones and, in particular, Eastern Europe.

2.3 Four Dismal Options

To solve the resulting competitiveness crisis there are only four dismal options.

First the Southern European countries dis-inflate or deflate in order to bring their prices down again relative to those in the North. This could be achieved with an austerity strategy. However, austerity is very painful. Prices and wages easily go up, but when they are supposed to decline, there is a lot of resistance. The unions tend to block wage declines vigorously, and many debtors would be driven to bankruptcy as they would not be able to service their debt. The latter is a particularly severe problem as the bubble arose due to excessive borrowing. When prices and wages decline, the creditors would often not be able to repay their loans and would go bankrupt.

The second possibility is to inflate the North, while the South keeps its prices constant. This seems to be the policy that the European Central bank is attempting by raising the average inflation rate to 2%. If this means that Southern Europe stays put and does not increase its prices, while Germany and similar countries inflate, the competitiveness could gradually be reinstalled. But will Germany accept a 10-year period where its inflation rate is 4 1/2% above the level in the South, and will the ECB even succeed in inflating Germany? Germany after all is a big tanker, which is very difficult to move. And once it has moved, it cannot easily be stopped again.

The third possibility is exiting the euro. Those countries, for which the path back to competitiveness within the euro system is too hard, could exit, devalue the new currency, become cheaper and regain competitiveness immediately (Klaus, 2015). If Greece for example reintroduced the drachma, the immediate devaluation resulting could easily make the country 50% cheaper. This would double the import prices and induce Greek buyers to stop buying foreign imports. For example they could stop buying tomatoes from Holland or olive oil from Germany, as they do, and turn to their own farmers instead. The farmers in turn would hire new people to help them satisfy the new demand. Moreover, rich Greek people who had fled with their money to other countries might return, buying real estate and renovating houses. This would create a construction boom. Finally, falling prices will likely give tourism a boost. All of this would quickly revitalize the economy and create more jobs for young people.

The Ifo Institute some years ago carried out a study based on 71 countries, which after the war had come into difficulties and devalued thereafter (Born *et al.*, 2012; Reinhart, 2009; Reinhart and Rogoff, 2010). It turned out that in the overwhelming number of cases a recovery took place very quickly one or two years after the devaluation. Devaluation is the strongest economic incentive conceivable for an open economy. It reinstates competitiveness very quickly. Of course it cannot work if a country is in equilibrium and is poor and stagnant for other reasons. But if a country has simply become too expensive in a bubble and cannot readjust its prices due to downward stickiness, then devaluation would result in a lasting improvement in competitiveness.

The fourth possibility is moving into a transfer union. This path has already been prepared by the actions of the ECB and the European rescue funds that replaced private capital imports during the crisis with public credit. There will now only be a small step from converting this credit to outright gifts.

2.4 What Will Likely Happen

Among the options presented above, none is truly satisfactory. From the view of ordinary economics, which places much emphasis on the liability principle and self-sustained development, the transfer union is the least attractive option of all, but that does not mean that it will not happen.

A transfer union means that the Northern countries finance a permanent flow of funds to the Southern countries to compensate for their lack of competitiveness and give relief to the intergovernmental rescue funds and the ECB. This will not only be expensive, given that 40% of the EU population would be recipients, not counting France itself. What is more, it would create a Dutch disease as explained above, keeping the recipient countries permanently in the situation where their wages are too high relative to productivity so that their price level stays above the competitive level. The lack of competitiveness would be sustained forever. There would be ongoing mass unemployment, while pensioners and everyone who depends on the state would be able to sustain their living standards. One generation of young people having difficulties entering the labour market would have to be sacrificed. The transfer union, at least some variant of it, is likely to happen in Europe, given that the new French president Emmanuel Macron has placed it high on his agenda and is now in a powerful position. Macron knows that after Brexit he has the largest group of supporting countries behind him. France's power has been dramatically increased in the EU, and he will use it, arm-twisting the other countries until they agree, to stabilize the French markets in Southern Europe. The Dutch disease, which is a long-run, structural phenomenon, will interest him less than the immediate pain relief resulting from redistribution.

To his advantage, the fact that President Trump as called the NATO into question makes the rest of Europe even more dependent on the French military forces, above all the Force de Frappe. Germany and other countries are becoming dependent on France and have to compromise.

In addition, Germany has become vulnerable through the Eurosystem, as that system allows unlimited imbalances in the euro-internal balance of payments. To be precise, by issuing local credit way beyond the liquidity needs of the domestic economies, the central banks of the crisis countries have enabled net payment orders to other countries, above all Germany, for the purpose of buying goods, redeeming debt with private creditors and buying assets. These payment orders must be carried out by the central banks of countries the resources of which are to be delivered to the crisis countries. The central banks executing the payment orders receive claims against the Eurosystem which itself builds up claims against the central banks of the crisis countries who made the orders. The claims are booked in the balance sheets under the item Target 2. At this writing, the German Bundesbank has open Target claims of 843 billion euros. The Bundesbank cannot call the claims due, and the majority of countries with a negative net-asset position in the Eurozone have decided to make the rate of interest on these claims zero.

The imbalances in the Target balances are pivotal to the mechanism that is driving Europe into a transfer union (Sinn, 2012; Sinn and Wollmershäuser, 2012). First came the bubble driven by excessive capital flows to Southern Europe triggered by the interest convergence, which itself resulted from the security the euro seemed to offer international investors. Then came the period after the outbreak of the world financial crisis, during which the Southern countries indeed had to use their local printing presses to redeem foreign debt, as is measured by the Target-2 imbalances. The self-aid with the local monetary printing presses forced the euro governments to step in with fiscal rescue funds serving as relief armies, which reduced the Target balances as they induced inverse payment orders. But the relief whetted the appetite for even more Target credit. As the Target mechanism worked so well, the ECB in 2015 enacted its QE programme. This programme allows the national central banks of the South to refinance the pre-crisis current account deficits of their respective countries by buying back the foreign-owned assets that had been sold abroad to finance these deficits. To be specific, the QE programme enables the Southern central banks to force their counterparts in the North, above all the Bundesbank, to credit the repurchase operations in exchange for new Target claims. The repurchase operations are planned to continue until the end of 2017 and have an overall volume of 500 billion euros for private and 1.8 trillion euros for government bonds. The level of Target debt of Spain and Italy resulting from their right to force other central banks to finance the repurchases rose to 794 billion euros up to now (March 2017), which is nearly as much as the 843 billion euro Target claims of the Bundesbank (April 2017) (European Central Bank, 2017).

The Target balances deprive Germany of its freedom of choice when it comes to construction of the new Europe and makes it susceptible to blackmail. Should the euro break up because Germany rejects a transfer union, the central banks of the South will all go bankrupt, because they hold euro liabilities, while their assets in terms of claims against local banks and local governments will be converted to national currencies, which will devalue immediately. And as the Maastricht Treaty is very explicit in excluding any liability of a state for its central bank, Target claims such as Germany's will have to be written off partially, if not fully. Thereafter, the governments of the surplus countries like Germany will have to recapitalize their central banks by handing government bonds over to them in order to absorb the excessive liquidity that was created with the payment orders in their economies to prevent hyperinflation. This horror scenario obviously makes the governments of the Target-surplus countries vulnerable and susceptible to blackmail. Understanding these risks and predicting what will likely happen does not mean it should happen. Sometimes a forecast opens one's eyes and leads to last-minute counter reactions that prevent the disaster.

2.5 What Should Happen: The Necessary Reforms

The kind of redistributive union that the Brussels establishment and the new French president propose is ultimately a dangerous concept that will lead Europe into a similar trap as the one that nearly led to the destruction of the United States of America. It would exacerbate and perpetuate the distortions created by the euro. In view of the US history reported above, for the time being only a decentralised Europe satisfying the Pareto Principle and giving up all mutualisation ideas will be able to prosper. In the following I describe a selection of the proposals for a new Europe that I made in my book *Der Schwarze Juni* (Sinn, 2016b) as a reaction to the results of the Brexit referendum as well as the decision of the German supreme court to subdue to the OMT ruling of the European Court of Justice, just two days before.

1) Breathing Currency Union

The first and most important Treaty change refers to membership in the Eurosystem. The current strategy of keeping all countries in by compensating the lack of competitiveness with ever more money and credit guarantees from other countries has calmed the financial markets. However, in violation of article 126 of the EU Treaty, which forbids the bail-out actions, it has also maximized the moral-hazard effect in terms of excessive borrowing, *i.e.* the type of behaviour change that nearly destroyed the US after only a few decades of existence. And above all, it was unable to create new jobs for the young. At best it has made the state able to sustain the living standard of its employees and the country's pensioners, who could then support their grandchildren.

The so-called rescue policy has instead harmed the economies of the South by driving them into the Dutch Disease, *i.e.* by sustaining wages and living standards that dramatically exceed the level implied by local productivity. International investors shy away from them, as they see no chance to create competitive jobs, and domestic firms have no chance to become competitive in international markets.

Instead of artificially sustaining a country's non-traded goods sectors with public or publicly guaranteed credit as well as outright transfers from abroad, it would be better to allow them to stand on their own feet by leaving the euro, returning to their domestic currency and devaluating. The devaluation would redirect domestic demand away from imports to domestic products. This would quickly generate new jobs and make the economy prosper.

Negative side effects such as medical problems resulting from increased prices for pharmaceutical products could occur after such an exit from the euro. The community of euro states could mitigate these consequences by subsidizing such imports for a transition period.

The exit does not have to be permanent. In fact, if the new exchange rate has found its new equilibrium and new economic sector structures have emerged, the country would be free to return to the euro at that new exchange rate under the usual entry conditions. The return option would give everyone hope and serve as a permanent incentive for the political parties to carry our reasonable structural policies so as not to risk this option.

A breathing currency union would be more appropriate for the European community than a Eurosystem that resembles a prison, not allowing anyone to exit. By creating jobs, it would stabilize the political systems and strengthen moderate political parties, which would want to keep the country in the EU and would not call the European unification process into question, as is the case today.

2) Bankruptcy Rules for States

In addition to the exit option the community of states should agree on the rules for an orderly bankruptcy of member states. The need for such rules to be specified in directives and regulations is basically implied already by article 125 of the EU Treaty. In the case of mere liquidity problems, which seem to have a temporary character and force the country to ask for help from the European rescue fund ESM, the owners of government bonds that become due will have to accept an extension of maturity instead of being bailed out with taxpayer money. If the liquidity problems vanish, the bonds can be called due as the country is able to replace old credit with new credit it can take at market conditions. If the problems persist, there was obviously more than just a liquidity problem, and bankruptcy has to be declared. In that case the owners of government bonds will have to accept haircuts. The bankrupt country exits the euro, perhaps only temporarily, so as to improve its competitiveness and creditworthiness through devaluation.

3) Monetary Policy of the European Central Bank at Minimal Risk

Risk-taking by the ECB at the expense of the taxpayers of Europe must be stopped, and so must be the systematic and permanent monetization of government debt by the European Central Bank, which is in blunt violation of article 123 of the EU Treaty (TFEU). The European Central Bank has to return to ordinary monetary policy, *i.e.* the ECB should stop and reverse it QE programme, in particular the part that refers to government bond purchases. Government bond purchases should be allowed only temporarily to calm markets and with the aim of soon bringing the stock of government bonds held by the national central banks as well as the ECB itself back to zero.

States that want the ECB to temporarily buy their bonds in the market and do not have a first-class rating must collateralize their bonds with first grade securities, if necessary real estate property. Otherwise, the ECB should not be allowed to buy state bonds even temporarily but limit its monetary policy to traditional refinancing operations against the first-rate collateral provided by commercial banks.

4) Settling the Target Liabilities

National central banks are forbidden to issue money and credit to the respective local economy beyond the proportional size of the domestic economy. If they deviate from this rule and issue more credit so that net payment orders to other countries are possible and if they print physically more than their proportional share of banknotes, they will have to settle the resulting liabilities *vis-à-vis* the rest of the Eurozone. Such settlement could follow the original rules of the United States of America at the time of the gold standard. Settlement can be done with gold or the first-rate marketable paper. Of course the respective central bank may not have enough gold. But as gold is just a means of exchange, it could buy it by selling other assets.

If the national central bank does not possess enough assets, the respective state should be liable. This is very different from today, where a national central bank operates like a limited liability company, which can go bankrupt without the respective nation state being in charge.

The need to carry out the settlement would reduce the national central bank's appetite to issue too much credit domestically so as to compensate for the lack of private credit from abroad. If less domestic credit is issued from the local printing press, interest rates will be higher. The higher interest rates will induce foreign private capital to flow in or limit imports from other countries that are either directly or indirectly, *e.g. via* government borrowing for wage payments, financed by foreign credit. Both will reduce the country's Target liabilities.

5) ECB Voting Rights according to the Liability and Size of the Member Countries

While today big and small countries have basically the same voting rights in the ECB Council, the voting rights in the future should be allocated according to the liability shares of the respective countries, which themselves depend on the relative country size or, to be precise, on the mean of the countries' respective population and GDP shares. Decisions of the ECB Council that have a fiscal and hence potentially redistributive character should be made with a qualified majority of 85%.

6) Home Country Principle for Inherited Benefits and Host Country Principle for Earned Benefits

Not only the rules of the European monetary system have to be adjusted. To overhaul the EU much more is necessary. To take up Cameron's proposal and stop the European welfare magnets, needy EU citizens and needy citizens from countries which are associated with the EU should not automatically become entitled to resources from their host countries. In general, social protection rights for EU citizens should be based on birth or on paying taxes and social security contributions. Except for unemployment benefits which require permanent availability for jobs, the citizens should be allowed to consume these benefits in any country of their choice. While claims for earned benefits like unemployment benefits and pensions are to be made in the host country where people have worked and paid taxes and social security contributions, other welfare claims that are unrelated to work are to be made to the home country or, to be precise, the country of nationality.

This system would provide full social support to all EU citizens given that the home and host countries all satisfy social minimum standards and it would fully grant the free migration, but it would make sure that the incentive to migrate because of welfare gifts rather than wage differences and employment possibilities is reduced. This would boost European growth and welfare.

7) Inclusion of Asylum-Seekers, but Asylum Applications outside EU Frontiers
Accepted asylum applicants will be integrated into the social system of a host country, which provides protection as to the domestic citizens, as long as the reason for asylum persists. Because of the practical difficulties of bringing non-recognized asylum seekers back to their home countries, the applications are to be made outside the EU frontiers, however, and will have to be decided according to common EU rules. For this purpose the EU should open application offices, though no camps, in cooperation with its neighbours on their territory.

If such cooperation is not possible, the EU should define extraterritorial regions on its own territory, similar to the island Australia uses. The applications there should be handled in the same way as today is the case for asylum-seekers coming by plane. Asylum applicants cannot leave these regions before they are formally accepted and if not accepted will have to return to where they came from.

8) Free Trade and Free Capital Movements without Free Migration for the EU's Neighbours
The EU should offer all neighbouring countries the status of an associated member. This status is characterized by free trade with goods, services and capital but allows for a limitation of free migration. EU countries have the right to move to the status of an associated member at their choice. This would be the appropriate status for Great Britain, and it would help the countries of the Near East and Northern Africa to improve their living conditions, thereby reducing the migration incentives.

9) European Subsidiarity Court
To limit the unnecessary accumulation of power by the EU, which is in blunt contradiction of the Subsidiarity Principle, a Subsidiarity Court of Justice should be established, as former German president Roman Herzog once suggested. The Court has the task to check whether EU projects, EU directives and EU laws are compatible with the subsidiarity principle of the EU Treaty, according to which only activities with a supranational meaning and spillover effect can be carried out on the European level. The proof that an activity cannot be carried out by local units has to be provided by the EU itself.

10) Common Army, Common Security Partnership
It was clear to the first generation of post-war politicians that to avoid a repetition of history, Europe should become a strong political union. They went so far as to sign a contract about a West European Defense Community with a common army. However, that contract was rejected by the French National Assembly. Instead of forming a political union, Europe instead moved towards an ever closer economic union. As far as free trade and free capital movements were concerned, this development was mutually beneficial for all countries. The difficulties started when the euro was introduced and welfare migration was not excluded. They will multiply if, in addition, a fiscal union is introduced without moving to a political union.

Now is the time to return to the origins of what a European political union could possibly mean: the disarmament of the nation states by joining the armies under a European umbrella, in particular the Frenche Force de Frappe. This not only would mean centralizing procurement to avoid parallel and incompatible weapons but also subordinating the command under European rule, making wars inside Europe impossible.

The countries must in addition coordinate their policy and security services and improve the communication between them. They should carry out a joint foreign policy in the range of security relevant issues, which however has to be limited such that they cannot be misused for economic protectionism.

Conclusion

These are in short main points, which I consider important for a peaceful and prosperous future of Europe. Europe should become a solid security partnership, whose economies are organized in a decentralized way based on the principle of liability and a maximum degree of local autonomy, abstaining from redistributive policies between nations. Redistribution would create losers who would have to be prevented from escaping with punishment threats, but a union based on threats cannot ultimately be stable and peaceful. We do not want to erect a new Soviet Union but a union that fosters peace and prosperity for its members.

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