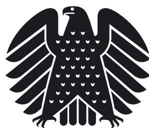

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A European Clearing Union – The Monetary Union 2.0

By Lisa Paus and Axel Troost[1]

1. Introduction

In recent months, the European Monetary Union (EMU) has been called into question like never before. The euro is in an extremely serious situation. This is especially clear in the fact that the media and politicians are no longer only predicting that the end of the Monetary Union would have unthinkably severe consequences. They have now gone one step further and are actually thinking through the supposedly unthinkable consequences. There is talk of individual countries leaving the euro, and of the Monetary Union breaking up into a North euro and a South euro. There is even speculation that Germany could return to the Deutsche Mark.

Up until now, the German Federal Government has largely advocated that crisis management in the EU and the eurozone should be based on traditional remedies, particularly budgetary discipline in crisis-hit countries like Greece, Ireland and Spain. But many European countries are increasingly – and justifiably – calling for further adjustment in the European Monetary Union system. The talk is of macroeconomic imbalances.

As will be explained in this paper, these imbalances express a fundamental defect in the structure of the European Monetary Union. We must use the current crisis to anchor a new economic and monetary policy model in the EU, and to reform the EMU. If we do not make lasting changes to the structure of the EMU, it will not be possible to keep the euro stable in such a way that benefits all participants and strengthens European cohesion.

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As a historic project, the EMU has not followed the economic theory of an "optimum currency area"[2]. Rather, it was a politically desired – and still desirable – project designed to increase European integration. However, a political project of this kind cannot be perpetually implemented against the rules of economy. The market alone forces weak member states to the edges of a monetary union. If we want the euro, we must take political action to steer all the economies within Europe towards each other so that they find their place in a monetary union.

2. The rules of a monetary union

A monetary union involves several countries coming together with the aim of pursuing a common monetary policy. The common currency benefits the national economies of the countries involved by removing currency crises and achieving cost savings in, for example, currency exchange and hedging. However, the participating countries also lose the exchange rate as a buffer that allows them to adapt to relative changes in their economic competitiveness. Decreasing competitiveness could, for example, be caused by prices rising faster at home than abroad. If the national currency is devalued as a result, then domestic products do not become more expensive for foreign buyers and the domestic economy remains competitive. Entering into a monetary union removes this instrument. From a purely economic perspective, national economies should therefore fulfil certain requirements before acceding. On the one hand, this includes the participating countries tending to react similarly to economic changes. This means, for example, that advances in productivity should result in higher wages in all countries. It is also important to note that devaluation of the common currency brings about a rise in exports and a fall in imports in all participating countries.[3] In addition to these "symmetrical" changes, asymmetric developments can also arise when economic changes take place in just one of the countries (e.g. a crisis in a specific industry that is of particular importance to a specific country). Those who support the optimum currency area theory argue that in order to deal with these kinds of "asymmetric shocks", all countries participating in a monetary union must have a highly mobile workforce and a high degree of price and wage flexibility.

When the European Monetary Union was being created, these conditions existed only to a very limited degree in the EU Member States, especially with regard to productivity-related wage fluctuation (see explanations below) and the requirement for a mobile workforce. As it is, the latter is highly questionable, given that cross-border workforce mobility is – not least because of language barriers – only possible to a limited extent. It should not be economically enforced; it should come about purely voluntarily. The fact that the eurozone was established despite these facts clearly shows the extraordinary

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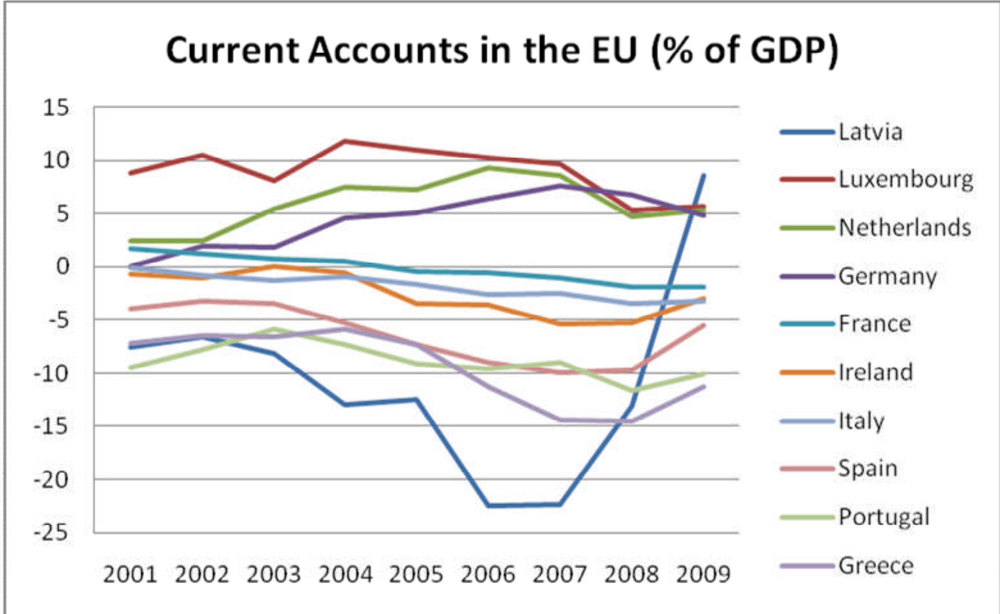
[2] According to the optimum currency area theory, those countries that display synchronous development and already have strong similarities in terms of economic structure are best suited to creating into a monetary union.

[3] Most countries meet this condition, known as the Marshall Lerner condition. However, if a country has an almost entirely inflexible import structure (e.g. made up predominately of essential foodstuffs or medicines), then devaluation will mainly result in higher import prices. A possible expansion in exports cannot compensate for this, causing the current account to slide further into the red.

political dimension of this integration process. The monetary union was designed to function as a kind of catalyst that would drive forward economic integration, thus strengthening the political union. This approach has its theoretical roots in the idea that the conditions for a monetary union could come about *ex post facto*, i.e. after the union has been formed. Thus, increased economic integration could synchronise business cycles.

Now, over ten years since the introduction of the single currency, it is clear that the expectations placed on the euro to act as a catalyst for the economic integration process were too high. In fact, some national economies have actually developed into different directions. A look at the development of the current account makes this abundantly clear. While Germany posted a current account deficit of -1.7 percent in 2000, it achieved surpluses that at times exceeded 7 percent over the following years. However, these surpluses are contrasted by deficits in other countries, such as Spain, Portugal, France and Italy (cf. Figure 1).

Figure 1
(list of countries in legend downward according to figures for 2009)

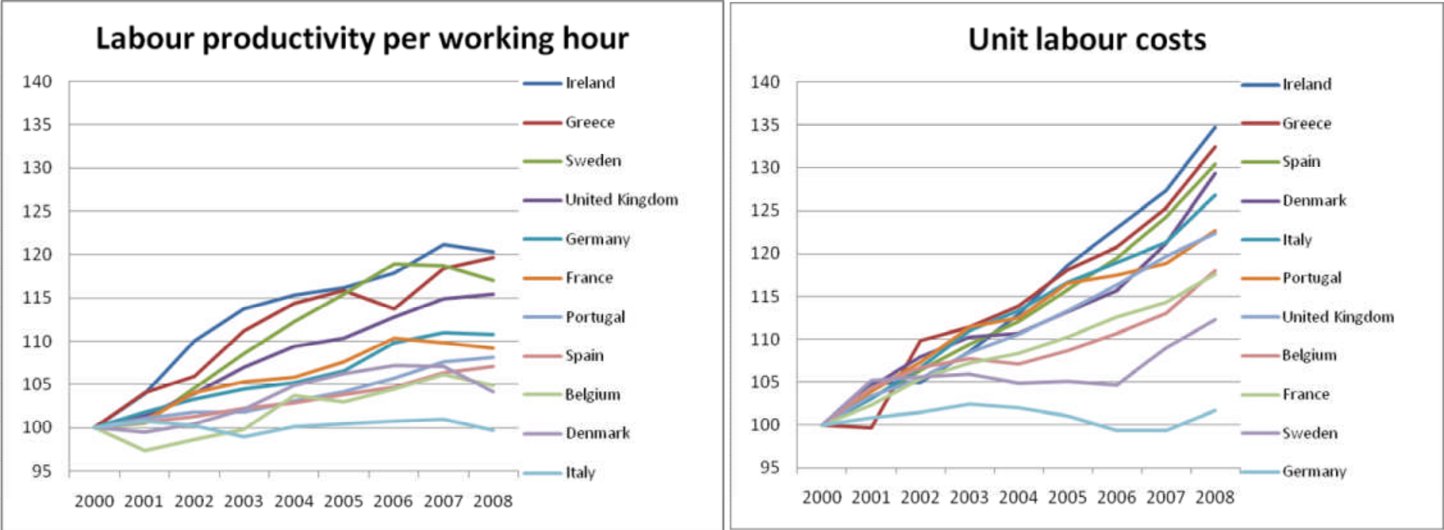


Source: IMF, World Economic Outlook, October 2010

This development is a result of the fact that wages have risen more slowly in Germany than in other countries in the eurozone. Lower labour costs gave the German economy a competitive advantage because it could offer its products more cheaply. Strictly speaking, however, the German economy benefited from low unit labour costs more than from low wages. Even with rising labour costs, companies remain competitive if labour productivity also increases. Since 2000, labour productivity in Germany has ranked in the middle, compared with other eurozone countries. In contrast, unit labour costs have been in continual decline since 2003 (cf. Figures 2 and 3). Even today, unit labour costs in Germany are only six percent higher than they were in 2000. In the rest of the eurozone they have risen by nearly 20 percent. Obviously, employees in our neighbouring European countries have not adopted the German fatalism that sees no

alternative to wage moderation. Instead they have succeeded in achieving better wage settlements within the distribution-neutral margin.

Figures 2 and 3
(Year 2000 = 100, list of countries in legend downward according to figures for 2008)



Source: Eurostat

These divergent developments within the eurozone highlight the failure of the market-oriented approach of the European Monetary Union.[4] Market forces alone cannot create the economic conditions for sustainable development of the national economies in the eurozone. This also applies to Germany. It is wrong to interpret the continuing current account surpluses as proof of Germany's strength. They are in fact proof of the erosion of the economic foundation of deficit countries. Sooner or later, rising current account deficits and declining economic power abroad will come back to bite Germany, and its economy will suffer as a result of bad debt and insolvency. Sustainable economic development in Europe is only possible if the national economies are, for the most part, in a state of external equilibrium. This economic policy model is nothing new for Germany. Section 1 of West Germany's 1967 Law to Promote Economic Stability and Growth includes a call for external economic equilibrium.

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[4] Any rational human being is bound to ask how the problem of national price and wage levels developing at different rates was taken into account when constructing the European Monetary Union. The answer is as short as it is shocking: not at all. And this was not the only fault in the EMU's structure. Having a standard official interest rate for the entire currency area increased rather than decreased structural and economic differences. Since there are always a certain number of regional differences in a monetary union, faster-growing countries continue to profit from what they see as low official interest rates because the official interest rate has to be aligned with the average economic conditions of the entire union. For countries with below-average growth, a "medium" official interest rate is still too high and means that the economy does not receive sufficient stimulus. The result is a hardening of different growth and inflation rates which, in the worst-case scenario (as in Ireland), causes massive bubbles (e.g. in the property sector) to form in fast-growing countries and puts countries with slower growth at risk of economic stagnation or even deflation.

Today more and more people recognise that the chosen approach to economic integration has led to a dead-end. This is why even peddlers of conservative rhetoric are making an about-turn and putting the emphasis back on the primacy of the political. However, in doing so they want to succeed where the market failed: implementing wage restraints and cutting social services throughout Europe. However, instead of a monetary union that is bound to particular interests, we need compensatory regulations that facilitate sustainable economic development for the benefit of every European citizen. A lack of compensatory regulations will undoubtedly lead to transfers. If Germany exports goods on credit that, in the end, have to be written off as a haircut as part of a mountain of debt when a country goes bankrupt, then Germany has given the goods away for free. The main aim of compensatory regulations must be to ensure relatively even current account balances. Work towards this goal must take into account a policy aimed at social equity.

The current debate: We need to balance current accounts, but how?

The European sovereign debt crisis indicates serious failings in the structure of the European Monetary Union. The current account imbalances that have accrued over a long period of time are proving to be one of the main problems – and not only for deficit countries. Even for countries like Germany that have current account surpluses, these imbalances represent a serious threat, as we saw when German exports collapsed in the recent financial and economic crisis. Therefore, almost all stakeholders and observers agree that we need to introduce measures for monitoring current accounts and for imposing sanctions when they deviate too far from a state of equilibrium. A number of proposals have been put forward as to how this can be achieved. Two particularly outstanding examples are the External Stability Pact and the Macroeconomic Scoreboard.

The External Stability Pact

Poor budget management is just one cause for the debt crisis in the eurozone. In the cases of Spain and Ireland, rocketing national debt is also down to government measures to stabilise the banking sector. This resulted in pushing Ireland's debt ratio from 25 percent in 2007 to almost 100 percent today. In just two years the consolidation endeavours of an entire decade were wiped out. Like Ireland, Spain had also chalked up considerable consolidation successes before the financial crisis hit. What was striking with Spain, though, was that the reduction of its national debt was accompanied by ongoing current account deficits. This was caused by private sector debt.

Sebastian Dullien and Daniela Schwarzer pointed out this connection back in 2009. They claim that a weakness of the European Stability and Growth Pact is that, by only focusing on national debt, it is blind to private sector debt. They therefore propose an external stability pact, which makes the current account balance its main criterion for assessing stability. The balance should not, according to Dullien and Schwarzer, exceed three percent of gross domestic product (GDP). Current account deficits and surpluses are permitted within this margin. Assuming a nominal economic growth rate of

five percent, this would limit cumulative foreign trade surpluses or deficits to 60 percent of GDP.[5] Up to this limit it is assumed that no balance of payment risks exist.

Unlike Spain, Ireland had comparatively low current account deficits when its public finances were in the consolidation phase. But Irish banks extended their loans to the private sector. This is why Dullien and Schwarzer also recommend observing financial sector debt as a way of recognising risks that are not reflected in current account balances.

The criteria of the External Stability Pact are intended to apply to surplus and deficit countries alike. Countries that do not adhere to the criteria should receive a warning. If a country violates the rules more than once, the punishment could involve reducing payments it receives from the EU, or ordering it to pay a fine. In order to limit the Member State's veto potential, the European Commission should be given more powers.

The External Stability Pact is a step in the right direction. For one thing, it not only foresees punishing deficit countries; it also threatens surplus countries with sanctions if they violate the terms of the agreement. In doing so, the Pact shifts the focus from the fiscal dimension to a more macroeconomic perspective. Instead of making national debt the benchmark for deciding whether a country is on the path to sustainable economic development, the proposal bases the political assessment on the overall balance of the economy.

Of course, we have to ask whether the threshold value of three percent of GDP is appropriate. These values only exert a stabilising effect with an assumed nominal growth rate of five percent. Yet growth rates can vary widely between countries. Those with higher growth rates can show sustainable development even with higher current account balances, while countries with lower growth rates should have lower balances.

The European Commission's Macroeconomic Scoreboard

Recent developments have proved that the Maastricht criteria are not capable of preventing a debt crisis of the kind we are currently experiencing. This is because the present crisis is not only due to poor budgetary policy but essentially to economic imbalances. Various European governments and institutions are therefore discussing what key indicators might be the most effective for detecting macroeconomic imbalances at an early stage. One of the things they have mentioned is a dataset, or "scoreboard", that could report on the status of the national economies. Current account balances will also play a key role in this scoreboard. Other indicators currently under discussion are net external position, real effective exchange rates based on unit labour costs, unit labour costs themselves, share of the export market, etc. (European Commission, 2011 a-f).

According to the European Commission, it is not intended to assign thresholds to these indicators, which, once exceeded, would trigger an automatic infringement procedure. Instead, the indicators would simply serve as points of reference to enable decision-

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[5] cf. Sebastian Dullien and Daniela Schwarz (2009): *Die Eurozone braucht einen außenwirtschaftlichen Stabilitätspakt* (The Eurozone needs an External Stability Pact), p. 5 f, SWP-Aktuell 27.

makers to assess the economic situation. Ultimately, there should always be a political assessment of the actual situation before an "imbalance procedure" is launched. In contrast to the Stability and Growth Pact, the current account indicator does not only consider negative divergence. Current account surpluses will also be analysed and politically assessed. This may well ultimately lead to an infringement procedure against the Member States involved, with corresponding recommendations.

This attempt to get a better picture of actual economic conditions using a broad set of indicators represents significant progress, particularly as it endeavours to obtain a symmetrical view of deficits and surpluses with regard to the current account indicator. However, this approach entails significant problems in terms of both data collection and data interpretation. The most important question is what the consequences would be if a country like Germany, for example, were to have current account surpluses over a longer period of time. To date there is no mechanism that can force Germany to take appropriate steps to reduce its surpluses. It is more likely that the German view, which says that other countries must become more competitive, will gain the upper hand within the European Union.

With its "Pact for Competitiveness", the German government has already demonstrated how it intends to remove macroeconomic imbalances. Under the guise of improving competitiveness, it will erode social benefits and squeeze wages. In the government's text, this is called "abolishing wage indexation", "stabilising real unit labour costs", or "adapting the pension system to demographic developments". This would force Europe to follow a path that the dominant economic powers have already successfully implemented in Germany: employees will be placed in a weaker position vis-à-vis companies in the competition for resources. We can see what this policy has led to in Germany – a rapidly widening gulf between income and wealth.

As long as the Council alone has the power to make decisions regarding macroeconomic imbalances, German dominance will lead to the scoreboard approach being mainly used to continue cutting the welfare state in Europe. This is certainly not the way to ensure sustainable economic development. Large-scale wage reductions within the eurozone would reduce purchasing power and weaken national economies, which would grant trade with countries outside Europe more weight than economic development. However, this logic means that increasing competitiveness would lead to current account surpluses vis-à-vis the rest of the world. This policy would thus simply shift the problems from the European stage to the global economy.

3. A new approach: a European Clearing Union

The most important lesson learned from the current crisis is that the model of an external balance between EMU members needs to be firmly anchored in the reformed EMU. The proposed "macroeconomic stability pact" is a step in the right direction, and the limitations on current-account imbalances are an important part of the European Commission's "scoreboard approach". These proposals to stabilise the eurozone do offer helpful approaches but do not go far enough, since a three-percent limit on the structural export surpluses of Germany, Luxembourg or the Netherlands would still lead sooner or later to excessive debt in other EU countries. In this sense, the following proposal could be termed an "external debt brake".

The proposal for a "European Clearing Union" given here takes up specific aspects of the current debate and combines them with a further-reaching proposal of historic note from the 1940s. Then, too, the aim was to draw fundamental conclusions from a major global crisis.

During international negotiations on a post-war economic order in the 1940s, the leader of the British delegation, John Maynard Keynes, proposed a system to clear current-account imbalances (see text box on the International Clearing Union below). The part of the plan that is probably of most significance for current discussions was that both countries with deficits *and* countries with surpluses had to take steps to keep their balances close to zero. Even then, Keynes himself lamented that the debtor nations bore the sole responsibility for current-account imbalances and their correction, although "the contribution in terms of the resulting social strains which the debtor country has to make to the restoration of equilibrium by changing its prices and wages is altogether out of proportion to the contribution asked of its creditors. […] The social strain of an adjustment downwards is much greater than that of an adjustment upwards. And besides this, the process of adjustment is *compulsory* for the debtor and *voluntary* for the creditor. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience" (Keynes 1941/1980: 28). Since this unequal treatment was not only unfair but also economically counterproductive, he proposed a system which would put "at least as much pressure of adjustment on the creditor, as on the debtor". "The main point is that the creditor should not be allowed to remain passive. For if he is, an immpossibile task is laid on the debtor country, which is for that very reason in the weaker position" (Keynes, 1941/1980: 49).

John Maynard Keynes' proposal for an International Clearing Union

In 1940, the British government commissioned John Maynard Keynes to develop a model for the global economic order of the post-war era.[6] In the wake of the Wall Street Crash of 1929, the ensuing Great Depression and World War II, the international movement of goods had more or less come to a standstill. The international financial system had been plagued by instability since the collapse of the gold standard in 1914 and had only been patched together thereafter. Keynes used the findings of his economic research to develop the model for an "International Clearing Union" (ICU) with three basic principles.

1. Creation of a supranational currency

Every country was to have an account with a newly created international clearing house which would handle and register all its foreign trade inflows and outflows. The unit of account was to

[6] Between 1941 and 1944, Keynes frequently altered and qualified his plans, primarily at the request of the British Treasury (finance ministry) and the Bank of England. (For an historic reconstruction see Keynes, 1980). His initial "Proposals for an International Currency Union" (cf. Keynes, 1980: 33 ff.) of 8 September 1941 foresaw much stricter sanctions for creditor nations than in the "Plan for an International Currency (or Clearing) Union" (ibid.: 108 ff.) that was finally doing the rounds as the Treasury's official discussion paper from late January 1942 onwards. It was a slightly adapted version of this plan (ibid.: 168 ff.) that Britain brought to the negotiations with the United States on the post-war world order from August 1942. However, the British delegation had a different view to the Americans on several important points and Keynes, as its leader, was unable to assert his standpoint. Negotiations were finally concluded at the 1944 conference in Bretton Woods, New Hampshire, with the establishment of the Bretton Woods system, under which the IMF and the World Bank were set up.

be a new supranational currency called the "bancor", which would be independent of national currencies. The idea was that this would overcome a major shortcoming of all previous global currency systems, which had always been controlled by the respective dominant country (until then pound sterling; since then the US dollar).

2. Free trade, limited capital movement, and economic policy freedom

The system was designed to stimulate world trade, while at the same time providing national governments with sufficient economic policy freedom. To ensure greater planning security in foreign trade, the exchange rates of all currencies were to be pegged to the bancor at a ratio that was fixed but could be adapted in the medium term. Parallel to this, each country was to retain sovereignty over its own monetary and fiscal policy to allow it to promote economic growth and employment as it saw fit. Fixed exchange rates and different national monetary policies – i.e. interest rates – meant that international capital movement had to be severely limited. Otherwise, every country's savings could always have been invested in the country with the highest interest rate, which would have led to dramatic changes in capital flows. This made the ICU the exact opposite of the pre-1914 gold standard system, which was characterised by free movement of capital but did not give individual countries or their central banks direct influence over their monetary policy.[7]

3. A system for clearing current accounts

A third basic element – one which, in view of the structural failures of the EMU described here, is particularly instructive – was a penalty mechanism designed to ensure equilibrium between current accounts. Any country that continually imports more than it exports inevitably ends up in a debt crisis because it has to borrow money abroad to cover its import surpluses. To enforce their claims, creditors generally impose strict savings measures on the debtor country. However, import surpluses in debtor countries are a logical consequence of trade surpluses in creditor countries because the sum of the balance of all trade around the world is by definition zero. Therefore, if debtors are to pay back their debts, creditors must be willing to do without trade surpluses. This was exactly how the ICU envisioned a symmetrical system that was designed to balance both sides. At year-end, the ICU accounts of countries with a trade surplus would be in credit, while those of countries with a trade deficit would show a debit balance. However, rather than allocating interest to credit balances and charging debit interest on debits (as is standard practice), the idea was to do exactly the opposite. Surpluses – i.e. credits at the ICU – would, just like deficits, be devalued via a progressive penalty tax. This would have created a general tend towards equilibrium. Credits and deficits would have been cumulated over time. Keynes also wanted to set upper limits for credits and debits with the ICU. He envisioned the upper limit for accumulated credits and debts being the average export earnings of a given year. Credits exceeding this would be automatically expropriated and channelled into the ICU's currency reserves. This would have made it impossible for extreme creditor positions to develop in the first place, and at the same time would have limited the sum of global external debt (i.e. deficits with the ICU).

In addition to these financial penalties, Keynes planned a package of economic policy penalties that would be applied depending on the degree of imbalance. Through an expansive fiscal policy, for example, a surplus country would increase overall demand and therefore also the demand for imports. Another potential measure involved significantly increasing wages because they also boost demand for (among other things) imports and reduce a country's competitiveness to a level that is tolerable for the rest of the world.

[7] Under the gold standard system, the price of money in circulation had to be fixed in terms of a specified amount of gold. To increase money supply, gold had to be imported. Because gold was used as payment in international trade, gold imports could only result from a trade surplus.

We also believe that at least 50 percent of the responsibility for creating and maintaining balanced foreign trade in the eurozone must lie with those countries that display high structural current account surpluses. We therefore propose a new version of the rules of the European Monetary Union. It combines the logic of the External Stability Pact and the Keynesian Clearing Union to create a European Clearing Union – EMU 2.0.

In a tightly interlinked economic area like the EU, it is of course impossible to expect every country to have a perfectly balanced current account every year. This is because there will always be short-term fluctuations in foreign trade. Therefore the model for balanced current accounts in the EU and the eurozone should be based on a mid-term average, e.g. over three to five years.

In concrete terms, our proposal for a European Clearing Union envisages the contractually binding establishment of a short-term and mid-term upper limit for current account imbalances in the EU. In the short term (i.e. within a year) and picking up on the External Stability Pack proposed by Dullien and Schwarzer, we suggest setting a fluctuation margin for foreign trade surpluses and deficits that equates to three percent of the country's GDP. This fluctuation margin should chiefly serve as a buffer for cyclical fluctuations. These occur when, for example, a country is experiencing a strong domestic economy with increasing imports while at the same time a recession in other European countries is causing exports to decrease or stagnate.

In the long term, however, current accounts should be balanced. Keynes's proposal could serve as a model for this. In addition to the short-term fluctuation margin of three percent of GDP, all countries would have an upper limit for cumulated imbalances of 50 percent of their average annual export earnings. Hereafter, this threshold value will be referred to as the "long-term upper limit".

A numerical example will help to illustrate this model. Country A has a GDP of €100. Of this – similar to Germany – 50 percent, or €50, is produced for export. The short-term fluctuation margin for current account balances is €3, while the long-term upper limit corresponds to 50 percent of €50 and is therefore €25. If, over four years, Country A achieves the maximum permissible annual current account surplus of three percent, then these surpluses will have amounted to €12, i.e. 12 percent of GDP or 24 percent of annual export earnings, after the four years are up. Given the long-term upper value of 50 percent of export earnings, it should therefore be clear that Country A cannot continue like this, because after seven years it will have exceeded the upper limit.

To ensure that countries comply with the short-term fluctuation margin and the long-term upper limit, the European Clearing Union naturally needs a binding process of staggered incentives and penalties. Much like the EU's current Stability and Growth Pact, our proposal would initiate infringement proceedings against any country that oversteps certain threshold values. Proceedings would begin if a country violated the short-term limit of three percent of GDP or if it exhausted half of the long-term upper limit of 50 percent of the export earnings. In both cases, the European Commission would send a warning that would oblige the country to make a public statement to the European Council and the European Parliament on how it intends to remove the imbalances.

Parallel to infringement proceedings, it would also make sense to introduce an escalating financial penalty mechanism. Similar to Keynes's Clearing Union, taxation should

deter countries from developing even minor imbalances. Countries would have to pay an annual penalty fee equating to one percent of cumulated imbalances that exceed 15 percent of the long-term upper limit. For accumulated imbalances over 25 percent of the long-term upper limit, penalty fees of two percent would apply. Due to the potentially weaker position of debtors, as described by Keynes, we propose additional incremental increases in the penalty fees that would apply only to accumulated surpluses. Surpluses that exceed 50 percent of the long-term upper limit would be liable for a four-percent penalty; surpluses over 75 percent of the upper limit would incur a fee of eight percent. The penalty fees would go into a fund that could be used to finance projects promoting European structure and cohesion. One of the key tasks of this fund would be to promote in surplus and deficit countries structural change aimed at clearing current accounts.

The penalty mechanism described should also be seen as a system of threats designed to oblige countries with current account imbalances to participate constructively in upstream forms of improved, deeper macroeconomic coordination within the EU. If the EU Member States align their economic, labour market, social, fiscal and structural policies in a sensible, forward-looking way, then there should be no problems when it comes to complying with the threshold values of the European Clearing Union, and to averting at an early stage the need for infringement proceedings.

If infringement proceedings need to be initiated nevertheless, then the warning issued should include a catalogue of recommendations on how deficit and surplus countries can reduce their imbalances. In its subsequent public statement, the surplus or deficit country must provide the European Council and European Parliament with an "external clearing plan". This plan will detail the measures the country intends to implement to reduce the imbalances. It must also react to the recommendations that were provided with the warning. If the country accepts none or only a few of the recommendations, it must justify this in detail and explain why the measures taken independently are equally effective.

The Council and the Parliament must both confirm, with a simple majority, that they believe the clearing plan to be fit for purpose. If at least one of the institutions fails to confirm this, then the country must revise and resubmit the plan.

If we look at how the euro crisis is currently being managed, we can see that there is no shortage of binding adjustment plans for crisis-hit deficit countries like Greece and Latvia. However, the dramatic slump in economic output in Latvia (-18 percent in 2009) and Greece (-4.2 percent in 2010) have shown that the current strategy of reducing debt through budgetary consolidation cannot work with negative growth rates. Either the methods are entirely unsuitable or they cannot function as long as the surplus countries are allowed – as Keynes said – to remain passive.

In the clearing mechanism for his Clearing Union, Keynes envisioned three penalty or adjustment channels: firstly, the compulsory revaluation and devaluation of currencies; secondly, financial penalties, especially for accumulated surpluses; and thirdly, political adjustment measures. Due to the lack of an exchange rate in the eurozone, only two of the channels come into question, so they must be applied with even greater vigour.

Therefore, alongside changes to the adjustment measures for deficit countries, it is very important that the catalogue of recommendations provided with the warning of infringe-

ment proceedings contain effective adjustment steps for surplus countries. Recommendations for surplus countries can roughly be split into two groups.

a) Measures to boost imports

Surpluses should be reduced by increasing the demand for imports. Under his Clearing Union, Keynes suggested measures for increasing domestic credit and consumption (Keynes 1941/1980: 80). Of course it would be desirable to achieve regionally differentiated increases and restrictions for credit within the eurozone through differentiated ECB monetary policy instruments.[8] However, there are strict limitations imposed on credit, so measures for stimulating consumption in surplus countries are of far greater importance.

Governments of surplus countries should in particular be advised to work towards increasing the average wage level, for example by raising wages in the public sector and in publicly owned companies. At the same time, they could increase employees' negotiating power in wage negotiations with the private sector by introducing and raising legal minimum wages, by reducing admission requirements and conditions for wage replacement benefits (e.g. assessment bases, job acceptance criteria) and by improving protection against dismissal.

By increasing government spending for public investments in socio-ecological restructuring (e.g. in the fields of education, energy efficiency, insulation, renewable energies, health, childcare, the environmentally-friendly expansion and renewal of rail passenger and freight transport, public transport and electromobility) and increasing government transfer payments for the unemployed, pensioners and other people with no or very low income, it would be possible to significantly strengthen consumption and therefore increase the demand for imports.

b) Structural change to reduce dependency on exports

In addition to expanding imports, it is particularly important for countries like Germany to reduce their dependency on exports and to gear production more towards their domestic markets. The strengthening of consumption would provide a major boost to this process from the outset, because it would mean that companies that have traditionally produced goods for export would finally have access to a considerably larger sales market in their own country thanks to increased domestic buying power.

There is no doubt that increasing the average wage level will reduce, to a certain extent, the competitive advantage of the export industry. But at the same time, we are also facing the tasks of converting our domestic economy into a climate-neutral one, and, as a result of demographic change, of creating new, high-quality jobs in the fields of health,

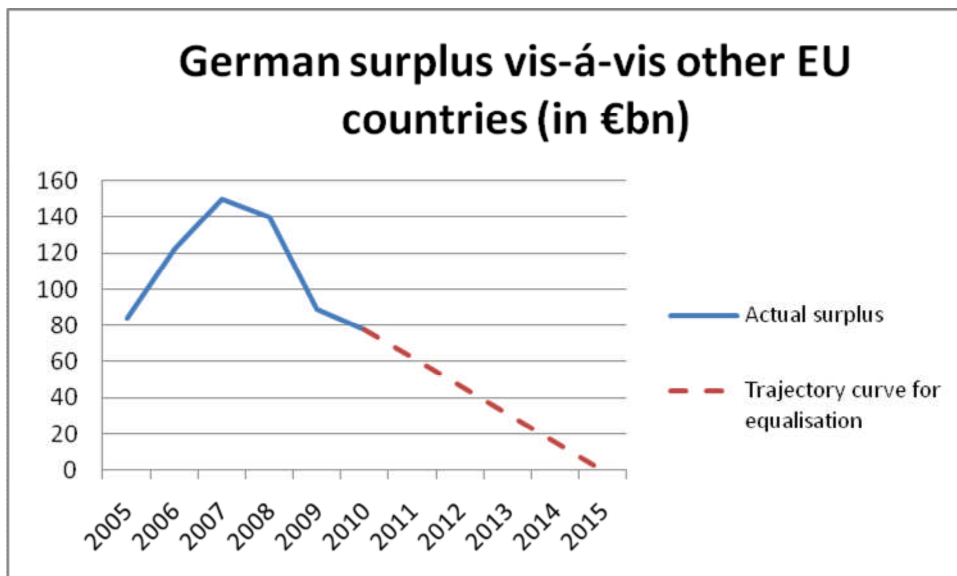
[8] Here it should be noted, for example, that many monetary policy operations will continue to be carried out in practice by the national central banks. This paper will not go into how restricted, nationally differentiated monetary supply conditions can be achieved. However, certain differentiations in minimum reserve ratios are conceivable, as is the introduction of regionally or sectorally differentiated minimum ratios for active reserves.

education and infrastructure. Strengthening domestic demand is a key pillar in structural change that is designed to achieve a sustainable economy.

4. Embarking on a European Clearing Union – a trajectory curve for Germany

At the beginning of a current account clearing system of this kind, all the countries involved would need binding trajectory curves for gradually reducing their imbalances over the next five to eight years until they do not exceed the long-term upper limit for imbalances by more than half. In the five years from 2006 to 2010, Germany accumulated a current account surplus of €580 billion with the other EU countries. If Germany wanted to reduce this surplus to zero in the years 2011 to 2015, based on a comparatively low surplus of €80 billion in 2010, this would correspond to a cumulative annual surplus reduction of around €16 billion (cf. Figure 4). The total reduction required for the complete five-year period would be around €230 billion.

Figure 4



Source: Deutsche Bundesbank, own calculations

Reducing structural surpluses with other EU countries by at least €80 billion would require Germany to increase its imports and reduce its exports. One useful import would be renewable energies from the sunnier southern European countries, as this would provide an opportunity to achieve the EU climate goals. Additional European investment would be needed to ensure that this solar power could replace oil and gas imports as soon as possible. The EU could provide incentives so that Germans would spend some of the savings they have put aside from their wage increases on forward-looking projects of this type.

If we assume that around two thirds of these real wage increases are spent on consumer products and at least ten percent of that on imports from abroad, that would

mean that each percentage point rise in real wages would lead to import increases of at least €36 to €48 billion, with around half of imports coming from the EU.[9]

In addition to stimulating the demand for imports, real wage increases also reduce the excessive growth (compared to Germany's European trade partners) in competitiveness German products have shown in recent years. Even if this does result in some companies, workforces and industries that operate in the export sector having to cope with order books that are no longer filled, there is no way to avoid it. One of the decisive factors in a structural change of this kind is the extent to which a country succeeds in balancing falling foreign demand with production for the domestic market. However, it will hardly be possible to fully offset the falling demand for products on the export market with sales of the same products the domestic market. For example, it would be impossible and undesirable to take fertiliser, a chemical product that enjoys strong export sales, and shift it onto Germany's already excessively fertilised fields. The idea of simply selling more German cars at home than abroad also overlooks the complexities of the situation. Germany mainly exports large, expensive automobiles that are more environmentally harmful than many of the smaller cars it imports from countries like France and Italy. We would therefore gain nothing in terms of the environment and efforts to reduce trade surpluses if we put more large German cars on our roads and stopped driving the smaller French and Italian models. Instead, structural changes could involve moving away from car engine production and towards using converted production plants to build mini power-plants for private basements. These could provide the flexible backup for wind and sun-dependent renewable energies that cumbersome coal-fired and nuclear power stations cannot offer.

According to calculations from the German Institute for Economic Research (DIW) and the Bundesbank, a one-percent drop in prices of goods from the manufacturing sector results in foreign demand increasing by about 0.9 percent on average (DIW Weekly Report 29/2004, Deutsche Bundesbank Monthly Report 1/1997). The DIW found that export prices in automotive production, the clothing industry and the timber sector are particularly sensitive. Due to high levels of automation, the share of wage costs in automotive production are relatively low (between 15 and 20 percent). If wages in this industry – like those in France – had grown by 15 percent more between 2000 and 2008[10] (cf. Figures 2 and 3), they would have pushed up production costs in the German automotive industry by around 2.5 to 3 percent. Given the figures from the DIW and the Bundesbank, German car exports would therefore have fallen by at least the same amount in the same period. A three-percent drop in car exports would reduce Germany's annual export surplus with the EU by around €3 billion.[11]

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[9] €2,500 billion (GDP) x 65% (share of wages in national product) x 67% (average prospensity to consume) x 10% (estimated minimum import share of consumption) minus VAT, minus approx. 50-60% for the revenue share remaining in Germany (retail, transportation, financial services, etc.)

[10] An "additional wage increase" of 15 percent initially seems unthinkably high. But distributed across the period 2000-2008, this would have only required annual wage settlements to increase by a far more conceivable 1.57 percent.

[11] With exports of cars and car parts totalling €155 billion from November 2009 to October 2010, a three-percent decrease amounts to €4.65 billion. In 2008, over 70 percent of car exports went to European countries.

In the interests of ensuring a more stable external development in Europe, there can be no question that Germany must move away from an overly export-oriented focus and begin paying greater attention to domestic demand. This will certainly involve moving away from the industrial sector, preferably towards well-paid jobs with adequate social security cover in the service sector. We are therefore talking about a long-term structural change – one that, like phasing out coal mining, will require a great deal of patience, a strong imagination and very active structural policy from all participating institutions, both public (Federal Government, *Länder* and municipalities) and private (businesses, unions, associations, etc.).

Even though the structural change outlined above represents an enormous challenge, its implementation is possible. Now is the ideal opportunity to help promote this change through the revision of Europe's macroeconomic system since it is unavoidable in the context of socio-ecological restructuring – not least for reasons of climate and environmental protection.

A new European regulation of this kind would be consistent with the legal situation in Germany. The obligation to adhere to macroeconomic balance contained in the Basic Law (Article 109(3)) was explicitly embedded in a European context with the most recent amendment to the article that was made as part of the Commission on the Modernisation of Federation-Länder Financial Relations. The macroeconomic perspective of this proposal therefore builds on existing legal foundations.

Unfortunately, the embedding in the European context that the amendment involved was achieved using the debt brake anchored in the Basic Law, and it is highly doubtful that this route will be able to contribute in any way to macroeconomic balance at all. However, making reference to the European framework is correct. The task is now to restructure the European framework for the purposes of a European Clearing Union or an External Debt Brake in such a way that will lead Germany back onto the path of macroeconomic virtue.

Here, a European Clearing Union represents nothing less than a modern-day, international application of the still-valid 1967 Law to Promote Economic Stability and Growth. Under this law, the Federal Government undertakes to preserve the overall macroeconomic balance by adopting, for example, economic and financial policy measures that contribute to ensuring external balance. The law also explicitly recognises the need to coordinate economic policies at an international level.

Rather than bringing the European project to a standstill with a European generalisation of Germany's recently agreed debt brake, an External Debt Brake should, following Keynes, prevent Europe from drifting apart and, by means of a Clearing Union, bring it together in a union based on solidarity and macroeconomic interests.

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