Conferenza internazionale
"Crisi economica e nuovi nazionalismi: la percezione della politica economica tedesca da parte dei partners europei "
Firenze, Auditorium Ente Cassa di Risparmio di Firenze
giovedì 15 novembre 2012

OIL AND VINEGAR. AN INSTITUTIONAL THEORY OF THE EURO CRISIS

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1. Oil and vinegar

It is known since antiquity that oil and vinegar can be stored in jars over many years. Nevertheless they are antagonistic. Oil is mild, vinegar is sour. Mixed together for a salad dressing oil and vinegar do not melt down in one mass, but they remain inimical as if the one would conquer the other. If the fight ends par, they separate at different places in the salad bowl. The equilibrium is characterized by either oil or vinegar.

From the point of view of production theory oil and vinegar are inputs which are neither substitutive nor complementary, but mutually exclusive. One can use the one or the other as an input but not both together. Exclusiveness is nothing extraordinary in economics. So Germany and France had their own monetary systems, Germany had the D-Mark and France the French Franc. Each monetary system had its complementary fiscal system. Germany's fiscal system was and is still decentralized and separated from the monetary system. Federal, state and local governments establish and balance their own budgets independently of the monetary system. Each element of the fiscal system has to break even (after allowance is made for debt) so that the monetary system has not to and must not subsidize the fiscal system. The French fiscal system instead builds on its subcentral budgets too, but their balance is made on the national level by aggregating all revenues and all expenditures letting cross-subsidize each other. The French national model is so to say a prototype of what under the euro became the "transfer union". The deficit which remained in the French national model after cross subsidization was balanced by debt and/or by central bank money. It is in the access to central bank money that the French national budget procedure differed fundamentally from its German counterpart for which financing by money creation was excluded.

Before the Maastricht Treaty of 1992 the German and French monetary/fiscal systems lived their own lives. Germany lived on oil/oil and France on vinegar/vinegar. Intra-system homogeneity went along with inter-system heterogeneity. No attempt is made to mix the oil and vinegar.

Maastricht, however, established a unitary currency under the European Central Bank which is strictly prohibited to subsidize member states' budgets. Therefore member states are constrained to balance their budgets without support of the central bank (in a similar way as under the D-Mark system). Each member state budget is supposed to break even (possibly with debt from the capital markets) without subsidization across member states. All member states are supposed to play oil. Too little attention was given to the fact that France entered the euro-monetary union with a national system based on vinegar. France was partially unwilling and partially unable to comply with Maastricht and to switch internally from vinegar to oil. The French government preferred to infiltrate the oil based Maastricht principles with French vinegar, in particular to extend its existing "national transfer union" of its one nation to the European level with 17 nations with a much larger redistribution potential than before.

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What were some billion euro transfers formerly within France are now trillions of euro transfers between member states to be paid by Germany and the other oil countries. A never ending crisis.
Germany was not resolute enough to enforce and to maintain Maastricht and to require France to play oil. Nor was Germany resolute enough to assume the French leadership and to play vinegar. Germany partially retreated from its tenets and allowed France to play vinegar though not fully. It accepted partially the transfer union, but was only step by step willing to pay for the implied transfers. So the other euro states were given incentives to test permanently how much Germany is willing to pay. Insults and street riots are part of this dubious conflict. Halfway ambiguity perfectly corresponds with my hypothesis that we observe one bailout package after the other with none being able to definitely solve the crisis. Rather are oil and vinegar mixed and generate conflict and crisis which is detrimental for all.
History has shown that a monetary/fiscal system with all players playing oil is viable as well as a system in which all players play vinegar. But the mix between both systems is detrimental and therefore not sustainable. If the actual euro collapses why should we not return to national currencies? This is what a large majority the Germans seem to prefer even when considering the transitory hardships which such an alternative involves. But as there is no way to bring such a proposal to a popular vote, a return to national currencies is unlikely to happen. Another alternative is a return to the monetary union of Maastricht. But given the fact that Germany was not able to maintain Maastricht against the French ambitions, it is unlikely that it will bring up the even larger courage to return to Maastricht. A last alternative is a departure to a unitary state. But a unitary state under which fiscal rule? Under decentralized break even (oil) or under unionwide cross subsidization and debt monetization (vinegar)? As Germany was not able to prevent an infiltration of vinegar into the oil system of Maastricht, there is little reason to reject the hypothesis that Germany will not be able to resist against the full take over of French vinegar, i.e. against the institution of a centralized state à la Française.
In the following sections I shall explain my hypothesis more in detail. I shall show that *stepwise bottom-up financing and budget balancing* have been the oil of the German fiscal system for centuries whereas *top-level balancing and financing of subcentral* budgets has been the vinegar of the French fiscal system since the French revolution and that both systems can work as long as they are separated, but that they are destructive if they are brought together. This hypothesis has nothing in common with the commonplace that Germans and French are different people, or even natural enemies. We rather assume that the Germans and the French are basically the same homines oeconomici acting in their self-interest, but that the structure of the inherited institutions is different giving their governments incentives to behave differently. Within the European Union it has become conventional to talk about "Germany" and "France" as if they were acting individuals. When I use this term for simplicity I mean the outcome of individual decisions in the governmental complex with all its internal incentives and constraints.
In section II I shall explain comparatively the functioning of German and French monetary and fiscal systems from its origins up to present. Section III describes the forerunners of the euro, in particular the system of Bretton Woods, the European currency snake and the European Monetary System EMS. Section IV explains the euro under the Maastricht rule, section V focuses on the reactions of France vis-à-vis the Maastricht requirement of fiscal break even which eventually caused the crisis. Section VI opens the alternatives before us.

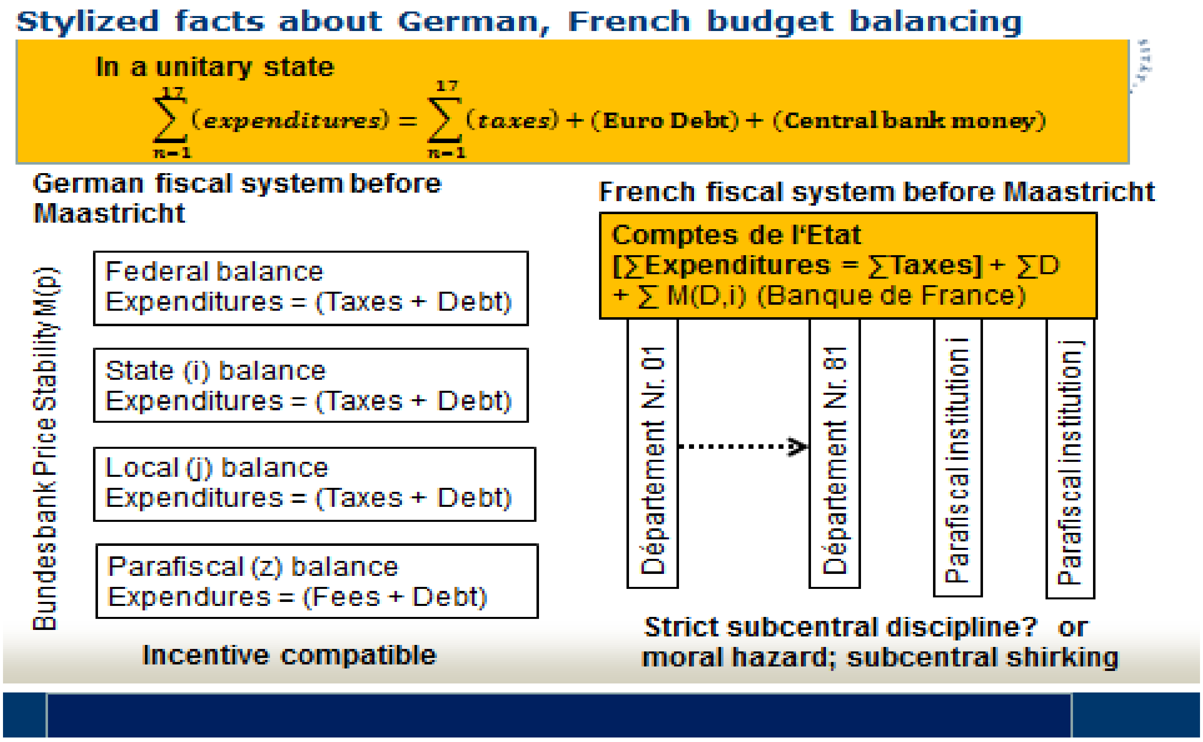
2. The German and French monetary and fiscal systems before the euro

In 1998 two thirds of the German population said 'no' to the euro. They objected to dismiss the D-Mark, their most important economic asset since World War II. They asked themselves: Why should we abandon what works and adopt instead the euro, an alternative which has been declared, but not proven to be equivalent. What the Germans thought was shared and supported by a large part of the German academia. In February 1998 155 German economics professors (including the author of this paper) launched an open petition to the government entitled: "The euro comes too early."[1] The petitioners' opinion was shared by a large part of their academic community worldwide. The most prominent person was Milton Friedman who remarked in 1999:

"I am very negative about the euro and I am very doubtful about how it will work out… What most troubles me … is that members of the euro have thrown away the key. Once the euro physically replaces the separate currencies, how in the world do you get out? It's a major crisis. As a result, I would strongly agree … that the euro should be abandoned before January 1, 2002. At the same time, the odds are very great that it will not be abandoned. The defects of the euro will take some time to show up; nothing happens very rapidly in this area. There are fewer than three years to go. Even if difficulties deriving from the euro occur in those three years, the political system is unlikely to react quickly enough to end the euro. As a result, I think it would be very desirable for some systematic thought to be given to devising some way to get out of the straitjacket of the euro after 2002."[2]

Friedman was among the first to predict that the euro will fail. Based on his lifelong experience he was able to judge what will work in an economy and what will fail. And he was right. Nevertheless he conceded that his doubts require a deeper theoretical foundation and suggested "some systematic thought". This task has still to be done. This will be the goal of the present paper. Many academics believe that the crisis roots in a failure of the financial markets. Much of this may be true. But I believe that we have to look behind the veil of financial markets and penetrate into the underlying institutions and the constraints and incentives they generate. These real institutions may create incentives seducing the individuals into risky financial transactions which eventually collapse.
But the starting point is the observation that Germany and France have different fiscal institutions with some agents playing oil and some playing vinegar which implies different ways how budgets are balanced and financed. A graphical exposition is given in figure 1.

[1] Der Euro kommt zu früh", Frankfurter Allgemeine Zeitung, 9 February 1998
[2] In a letter to Antonio Martino, Cato Journal, Vol. 28, No. 2 (Spring/Summer 2008).



Source: Own compilation

Germany is depicted on the lower left hand side as a country which has grown out of the evolution of the middle ages. Early peasants insured themselves under the vassals against bellicose encroachments of invaders whereas vassals insured the seigneurs and were reinsured by the seigneurs (Volckart 2002). This network of private contracts embodied the Holy Roman Empire in the middle ages. An aggregation of these local networks into states took place in the 18th and 19th centuries (in particular under Napoleon). In a last step the German Kaiserreich was founded in 1871 still more as an association of states than a state out of which the Weimar Republic and the Federal Republic of Germany emerged in the 20th century. At every stage of development the larger institution (principality, Kingdom and Kaiserreich) has been superimposed on the pre-existing smaller territorial entity which was preserved in the new entity rather than destroyed. Therefore each of these entities has its own budget which it balances with own revenues and debt under its own government as depicted on the lower left hand side of figure 1. So local, state and federal budgets and the parafiscal institutions (such public enterprises) form the ensemble of Germany's self-sufficient public finances. None of these entities has access to the money printing press. The Bundesbank which was founded in 1948 was under the strict legal obligation not to accept any orders from political authorities to monetize public debts. Therefore the Bundesbank is depicted apart the governments on the left hand side of the lower part of figure 1. The task of the Bundesbank is to maintain price stability and to stay outside politics.

Traditional France is depicted on the lower right hand side of figure 1. It originated from the same feudal system of the middle ages as Germany. But it was completely reorganized in the French revolution of 1789. Following a plan of abbé Sieyès France should be subdivided in 80 départements of 17 square miles each plus one département for the city of Paris. The plan was adjusted to geography and adopted by the general assembly with little changes in November 1789. In 1800 Napoleon created the system of the préfets consisting of centrally appointed (not elected) officers who had the task to execute the national policy and the national budget in the départements. Departmental finances from own source were of subordinate importance. Even today, after the French decentralization reform of 1982, the departmental and local budgets encompass no more than one third of the total subcentral expenditures.

The prefects, once in office, have large powers. In practice, however, they do not act in a political vacuum, but rather under pressure of the departmental and local interest groups of the notables. As most budgetary decisions are made on the national level these local groups do not feel responsible for the national budgetary consequences of their goals. They know that on the national level a great cross-subsidization (in fact a national version of a "transfer union") takes place between revenue ministries and spending ministries. They have therefore an incentive to free ride via the préfet on the national budget. For what should the national budget authorities do if the sum of the expenditures exceeded the sum of the tax revenues? They resort to public debt up to the point where interest rates dared to increase too much. At this point the French national government had a second option before the euro. It could resort to central bank money to balance the budget and so prevent an excessive increase of interest rates (at least in the short run).

The idea of national budget balancing in France is expressed on the lower right hand side of figure 1. What the départements and the para-fiscal institutions have spent is symbolically represented in the vertical bars, which are then aggregated in the horizontal bar on top. There the balance is made of

(1) $(\sum \text{expenditures}) = (\sum \text{tax revenues}) + \text{national debt} + \text{Central bank money}.$

What can be concluded from comparing German and French budget processes up to here?

1. The French method of top level budget balancing implies a common pool problem and hence a soft budget constraint for subcentral and parafiscal institutions which has to be less expected in Germany where each subcentral unit has its own means and own budget constraint. The tendency to subcentral budget shirking and moral hazard is therefore likely to be more pronounced in France than in Germany.
2. The access to central bank money in France reinforces the tendency to deficit spending compared to Germany.
3. The long lasting use of the central bank for balancing the budget has created different perception of what a central bank is and what it should do in France and in Germany. In France the idea is prevalent that the central bank is a reserve pool for top level budget balancing. This is what I mean with vinegar. Germans, in contrast, believe that the subcentral governments and the parafiscal institutions finance themselves with own revenues and if necessary by own debt whereas the central bank stands outside the budget process and has the only task is to maintain price stability. In this sense the participants play oil.
4. As long as the European Union had only the purpose to promote open markets in goods, services, capital and labour, the German and French systems of budget balancing could perfectly co-exist. One worked with oil, the other with vinegar. It is true that deficit spending in France generated a higher average rate of inflation as compared to Germany. But this required a devaluation of the French Franc or a revaluation of the D-Mark from time to time.

3. Monetary cooperation before the euro

1. Bretton Woods

The problem of oil and vinegar, however, matters as soon heterogeneous fiscal systems are put under the roof of a unitary monetary system. This happed already under the monetary system of Bretton Woods of 1944. Bretton Woods required each participant state to maintain a fixed exchange rate to the US Dollar. If a government decided to finance its budget by money creation (vinegar) it soon had not enough Dollars to maintain the fixed exchange rate and was constrained to return to balanced budget policy. Hence each country had an incentive to practice budgetary discipline. This rule was, however not binding for the United States. If they decided to go off balanced budget policy, they could always print Dollars without any consequences. In particular after they gave up their promise to convert dollars into gold at the fixed rate of 35 Dollars per ounce of gold in the 1960ies they could play vinegar while the other countries had to play oil. The US fiscal system was in disaccord with the fiscal systems of the other participant states. In 1973 the participant countries refused to buy any longer Dollars at the statutory exchange rates and so caused the collapse of the System of Bretton Woods. The example shows lucidly that national fiscal systems must be in harmony, e.g. they must break even, if a common monetary system is supposed to work. If the fiscal systems are in disaccord the common monetary system will break apart; oil and vinegar will separate.

2. The European currency snake

As early as 1972 when the Bretton Woods system was already in disarray the heads of the EU central banks decided to establish a system of limited exchange rate fluctuations between their currencies and the US Dollar illustrated by a “snake creeping in the tunnel”. After the ultimate collapse of Bretton Woods in 1973 the snake crept out of the tunnel. In response it was decided among the European countries that each central bank had to buy or sell its own currency in order to maintain the exchange rates within a band of +/-2,25%. The governments opened further talks within the so called Werner Plan on harmonizing the fiscal policies underlying their common exchange rates. But no binding decision has been reached. So Germany and France as well as several other countries started with inconsistent fiscal systems. Germany practiced a fiscal breakeven, France did not and was followed by a few other countries. Hence some countries were able to stay in the snake because they balanced their fiscal accounts, others borrowed from their central bank and therefore dropped out. Eventually only Germany, the Benelux Denmark and Norway were able to keep their exchange rates within the snake.

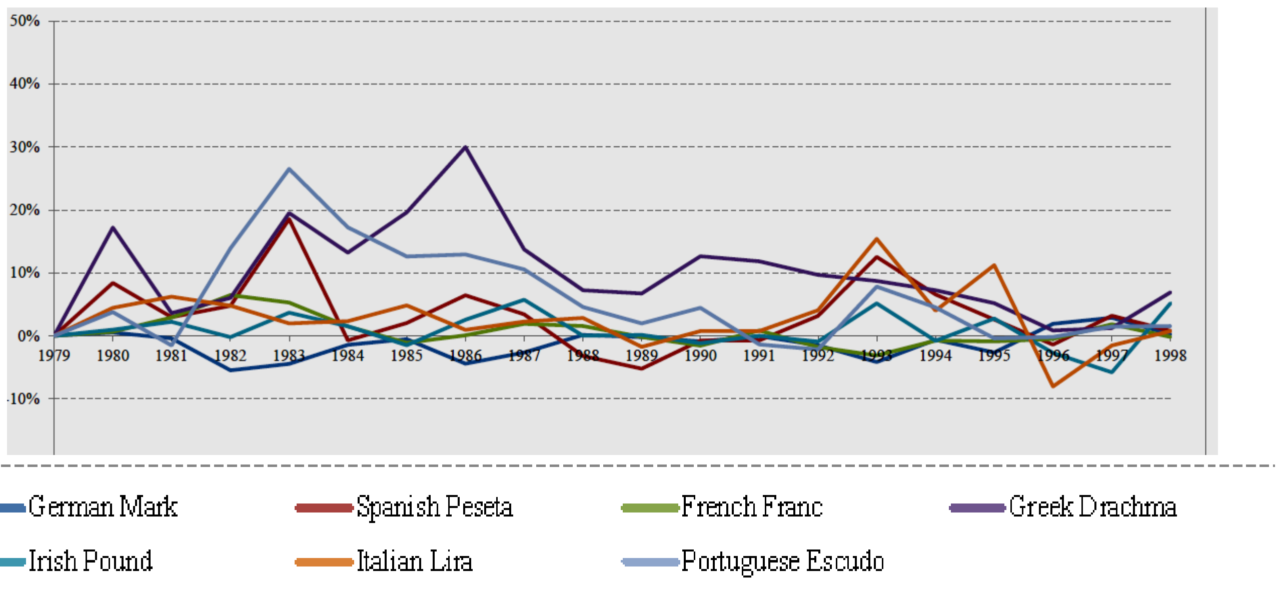
3. The European Monetary System EMS

The European currency snake was complemented with a 3 months monetary assistance mechanism of about 1,4 bn. European Currency Accounting Units (later ECU) (s. Bernholz 1998 p. 792). This help was enough to cope with frictions on the foreign exchange market, but unsuited to absorb asymmetries as those between the German and French fiscal systems. Therefore President Giscard d’Estaing came to Hamburg in 1978 in order to convince Chancellor Helmut Schmidt to extend the existing currency assistance open-endedly in anticipation of a future European monetary union whose central bank should be equiped with enough money to balance the European fiscal accounts as the Banque de France did on the French national level. This view was vigorously supported by the Belgian-American economist Robert Triffin (1960) who, as an

advisor to the European Commission in the 1960ies, pleaded for European reserve pool to support national governments' budgets. Germany's central bankers, in contrast, pointed to the Bundesbank law which strictly prohibited such support programs as the Bundesbank has to maintain price stability in the first place. This view, however, was completely alien to French politicians. They thought that a central bank that does not balance budgets is useless. The Bundesbank again rejected this view.
After some negotiations the German and the French side agreed with the other member states on a compromise which can be summarized in four stages:

- First stage: A short run frictional financial support program inherited from the European Currency Snake at 11 bn. ECU.
- Second stage: A medium term financial support program of another 11 bn. ECU.
- Third stage: A realignment of the exchange rates should take place in case of a fundamental exchange rate disequilibrium.
- Fourth: An automatic exit occurs if the first three options do not succeed.

The EMS was a good compromise to unite oil and vinegar countries. France was not constrained to abandon its fiscal system inherited from the past, but was warned not to overdraw it. It could count on monetary support, but it was made clear that support was limited. It is often said that the currency crisis of 1992/93 was a crisis of the EMS. But this is not correct. The crisis occurred because UK and Italy who were hit by balance of payment deficits resisted against a realignment according to the third stage above and therefore had to leave according to stage four. France was in a similar situation, but it achieved a broadening of the exchange rate bands to +/- 15% and therefore escaped from a realignment.
That the EMS was a success can be seen from figure 2 which represents the decline of exchange rate volatility over the 20 years of its existence. It is true that other factors such as the expectation of the euro and the need to fulfill the Maastricht criteria contributed to the favourable performance of the EMS. Nevertheless it can be seen from figure 2 that good rules can contribute to monetary stability.



4. The reasons of the euro

If n-1 countries of n participant countries of a fixed exchange rate union intervene to maintain their exchange rates at the agreed level, the exchange rate of the n-th country is also fixed whatever its monetary policy. The n-th currency will be the reserve currency. Which country's currency will turn out to be the reserve currency depends on its stability. In order to be on the safe side the countries will attach themselves at the country with the highest reputation for price stability. So the D-Mark became due to its stability policy the reference currency for all other currencies. Therefore the D-Mark has often been characterized as anchor currency of the EMS. It turned out that what has been decided Monday by the Bundesbank in Frankfurt was reproduced Tuesday in Amsterdam, Brussels, Luxemburg, Vienna and last not least in Paris. That the Bundesbank became the leading institution of the EMS has generated a political malaise in France. With price stability as the dominant variable the French fiscal system came automatically under pressure. Whenever the Bundesbank increased the rate of interest, France had to follow at the cost of economic growth. German oil crowded out French vinegar. Therefore France wanted to get rid of the so called "di*k*tat allemand".
But France was in a dilemma because its budget deficit required capital imports which were, however, only available at a high interest rate which in turn limited its GNP. In figure 3 this is symbolized by GNP1. A larger GNP2 might be feasible if an exogenous power brought in capital and reduced the rate of interest, see dotted line.

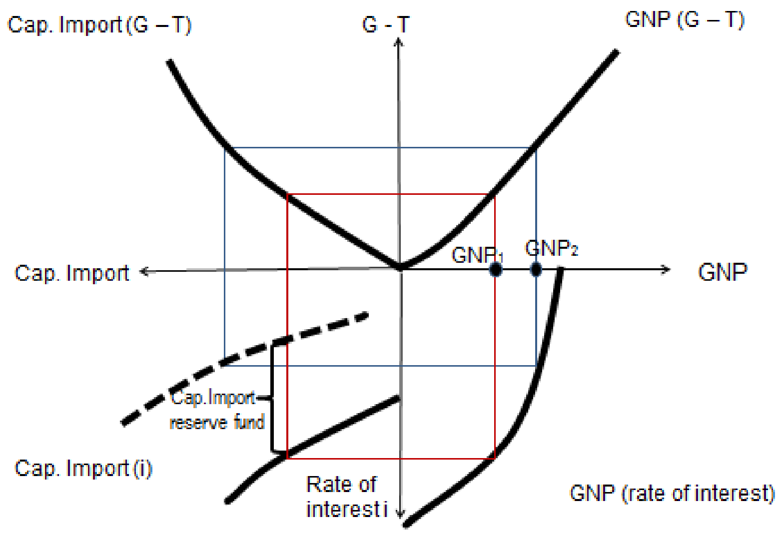


Figure 3: The French dilemma
Source : Own graph

But how could the additional capital come in? In the discussion around the Delors Report (Delors 1989) the idea of a European reserve pool of the 1978 EMS re-emerged (Maes 2002). Obviously the reserve pool should not only serve France, but all member states with the effect that the horizontal budgeting bar of France in figure 1 is shifted upwards encompassing all national budgets of the Union member states. Now equation (1) is transformed into equation (2) encompassing all 17 or more euro union states.

$$(2)\ \sum_{n=1}^{17}(\text{expenditures}) = \sum_{n=1}^{17}(\text{revenues}) + (\text{EU debt}) + (\text{Central bank money})$$

Under this proposal the aggregated revenues and expenditures of all union states are pooled and balanced with additional union debt (such as Eurobonds) and with money from the reserve pool which takes the role of a not yet existing European Central Bank. A country with decentralized budget balancing and fiscal break even such as Germany would automatically pay for the deficits of the countries practicing French type budget balancing ending with a national budget deficit. So a transfer union would emerge. Oil will retreat and vinegar will dominate. The best what Germany could do is to give up fiscal breakeven of its subcentral units, to play as France and to switch from decentralized to centralized budget balancing too. But this is prohibited by Germany's Basic Law which requires irrevocably Germany to be a federal state (Art. 20 para. 1 BL). The worst of all situations emerges. Oil and vinegar fight against each other. The Union States led by France will exploit Germany while Germany takes action to restrict centralized budget balancing.
Note that the described scenario remained hypothetical in 1988 because France did not obtain the German consent to introduce unionwide common pool financing. But the intentions of the French critique in 1988 were quite clear. How should the German government react? France was disgruntled with having to play oil in the EMS, and Germany rejected the vinegar which was preferred by France. Well, Germany could simply say to France: Sit out your concerns. We have the EMS. It works. It is the status quo. If you prefer a different monetary system you have to make a proposal and find a new consensus. But the German government, instead of pursuing the "German goals", felt obliged to pursue "European goals" whatever this means. It made a decisive step by proposing the plan of the euro which required dismantling the Bundesbank and giving up the D-Mark, indeed a high price (which the German population ostentatiously was not willing to pay, see section II). In fact the French side was rather astonished as it never expected that Germany was willing to make so far reaching concessions (Lindenlaub, 2008).
Despite of these concessions France did not receive what it wanted: a common pool budget. Instead it was obliged to comply with the Maastricht rules.

5. Dismantling the Maastricht Treaty

The Maastricht Treaty required from France to play oil instead of vinegar. France was supposed to break even its budget from the bottom to the top. National budget balancing has to be achieved with own revenues and debt from the capital market only without recourse to the central bank. Hypothetically France could have transformed itself into a federal state and become a second Germany with decentralized budget balancing. But such an idea is beyond any reality and has never intended nor even discussed in the negotiations of Maastricht. Each member state was allowed to maintain its traditional methods of budget balancing. It had only to break even. That the way to break even was much more difficult for France than for Germany (which was already on breakeven) has been overlooked. On the other hand Germany had o lever to constrain France to fulfill Maastricht. What is the consequence? France had strong incentives to get around Maastricht, in particular to reintroduce central bank financing and to enforce common pool financing of the Union budget. The French government has pursued this goal in three ways: (1.)

by negating the Maastricht Treaty, (2.) by staffing the ECB with its own paladines and (3.) by abolishing the no-bailout clause and introducing a fiscal common pool system.

1. Ce n’est pas vrai

Remember that the Treaty of Maastricht has been solemnly signed by the Heads of State and of Government including the French President François Mitterand February 7, 1992. But for becoming Law the Treaty had to be approved also by the French voters. This was the will of the president. But voters’ decision was far from predictable. Therefore President Mitterand thought that he had to attract more voters and to promote the public opinion in favour of the Treaty. In a television broadcast of Sept. 3 1992 he explained the Treaty. When he came to the role of the European Central Bank he said :
« [J‘]entends dire partout … que cette Banque Centrale Européenne sera maîtrise de ses décisions! [indépendante] Ce n‘est pas vrai! La politique monétaire appartient au Conseil Européen et l‘application de la politique monétaire appartient à la Banque Centrale, dans le cadre des décisions du Conseil Européen. »
He said that it is simply not true that the European Central Bank (ECB) shall be independent. The responsibility of the monetary policy will be with the European Council and the bank’s task will be the execution of the Council’s decisions. When 17 days later a tiny majority of 51% accepted the Maastricht Treaty it is not clear which Treaty the marginal voters voted for: the official version or Mitterand’s version. If the marginal voters voted for Mitterand’s version, the whole Treaty may have to be considered in a more French way. Getting around the tough rules was politically indicated.

2. Staffing policy in the European Central Bank

François Mitterand was succeeded as president of France by Jacques Chirac in 1996. As the start of the euro approached it became important to bring the right persons in the relevant functions.
A key position is that of the President of the ECB. In May 1996 the governors of the national central banks (NCB) selected Wim Duisenberg (the governor of the Bank of the Netherlands) with approval of the heads of state or government. In a second vote of December 1997 the European Council, however, failed unanimity because President Chirac insisted on Claude Trichet though Duisenberg has already been elected. After a distressing discussion between President Chirac and the other heads of government it was agreed in May 1998 that Duisenberg will step down of his office after four years and that Trichet will enter thereafter for eight years. This swap resulting from blackmail was illegal because an existing decision has been cancelled and because the Treaty requires that the office of the President of the ECB lasts eight and not only four years (art. 109a (2) (b) EC = art. 283 TFEU) (Warleigh 2002).
Furthermore it is questionable whether Trichet was an independent person (as required by art. 109 a (2) (b) EC and art. 282 TFEU) given his previous involvement in a scandal of the Crédit Lyonnais. As a Directeur du Trésor from 1987-1993 Trichet was moreover responsible for the French monetary policy and known as one of the fiercest critics of an independent central bank in the coming monetary union. As a defendant of the French version of Maastricht, he proved himself as a faithful paladin of his president Jacques Chirac who could rely on Trichet’s loyalty even when he will be outside his control as a president of the ECB.
Trichet once in office did not disappoint the expectations of his president. During the first half of his office he was restricted by the regulations of the Maastricht Treaty and the law-abiding

majority of the ECB governing council. With the banking crisis of 2007/2008, however, the majority of the ECB governing council changed its opinion. The members of the council became hungry for credits for their countries whatever the legal regulations. The political demand for money encouraged Trichet to start his securities markets programme (SMP) monetizing public debt for some states at the costs of all states.

On the one hand Trichet's purchasing program clearly violates art. 123 TFEU which says:

"Overdraft facilities or any other type of credit facility with the European Central Bank or with ... public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments. "

In addition the European Council clarifies: "purchases made on the secondary market must not be used to circumvent the objective of that Article",[3]

which means that purchases of euro government bonds by the ECB are clearly prohibited, irrespectively of whether they come from a member state directly or indirectly through an intermediary. Without prejudice the bank may, however, non-euro securities without limit for the purpose of monetary policy (Homburg 2012).

On the other hand Trichet's purchases of euro government bonds have been approved by the ECB governing council (under opposition of the German members Axel Weber and Jürgen Stark who withdrew under protest). The vote on the SMP may have been illegal, but it has nevertheless created a new status quo, a fact which cannot be defined away. In order to cancel the Council's decision someone should to bring a charge before the European Court of Justice with small hope of success. Given the high costs of such a charge it has rather be expected that nobody opposes. It can often be observed that when a regulations prescribe "no" and a high level collective decision results in a "yes" the latter dominates over the former. Or more generally: Procedural norms dominate over statutory norms.

German negotiators apparently disregarded this experience from practical politics. They insisted that the regulations of the ECB be written in the Maastricht Treaty, but forgot to consider the factual power of the majorities of the ECB governing council. They thought that as long as the regulations hold the German tenets are not in danger. It has also been said that the regulations in the Treaty are even stronger than those of the national Bundesbank law (Scharrer 1992, p. 212). The responsible Germans could not imagine that majorities can overrun regulations, as a majority vote cannot decide what is already prescribedin regulations. Therefore they accepted an enormous asymmetry. Though Germany contributed 40% of the working capital to the ECB (Sinn and Feist 2000), it received only 11% of the votes in the ECB governing council in 1999. It turned out that Germany received the same voting power as France who contributed only 11% to the working capital. Germany has one national delegate in the ECB governing council as many as Malta or Cyprus. Hence Germany is in a desperate minority position as it has missed to insist on a veto right into the Maastricht Treaty. Therefore the principles of the Bundesbank were easily thwarted by the council majorities.

Trichet achieved with his SMP policy an old French political demand. He transformed the ECB into a budget equalization fund for the member states with balance of payments difficulties (see III.3 above). He created rights for some to obtain funds against the obligation of others to pay. So he brought vinegar into a system based on oil. There is no natural halt. The crisis deepens itself.

3. The abolition of the no-bailout clause

The infringement of France into the Union's monetary constitution was followed by its infringement into Union's fiscal constitution. Remember that France has practiced national budget

[3] Council Regulation (EC) No 3603/93.

balancing with the help of the Banque de France before Maastricht. As Maastricht has withdrawn budget balancing with central bank money it seemed logical and in the interes of France to transform the existing "national transfer union" into a "unionwide transfer union" with inclusion of the ECB as explained in the previous paragraph 2 above.

The first country that came under EU budget balancing is Greece. As Greece has become insolvent in April 2010 it was decided that not the no-bailout clause shall be applied, but rather a bailout scheme distributing the Greek budget deficit on all EU-member states. The decision to bailout Greece presumably comes from the European Commission who made a proposal to the Council after intensive pressure of the banking lobby.

But the Greek bailout was only the first step. A bailout scheme encompassing all euro states was established by the heads of state and government in their summit of May 7/8, 2010.

How was this possible? How could a core constitutional principle such as the no-bailout clause be eliminated in one night? Following a detailed report of the summit by Peter Ludlow (2010), Claude Trichet was again the driving force. Trichet was not a member of the summit. But he participated as a guest and took the opportunity to start the session by explaining the situation of the European government bond markets with help of PP slides. He scared the participants by describing a drastic picture of the market especially for the peripheral euro countries. Indeed government bond rates declined during the first half of the current week despite of the bailout of Greece the week before. But rates recovered after the German Bundestag formally approved the Greek bailout program (May 6, 2010). Nevertheless Trichet warned before a disaster which might happen when next Monday, May 10, 2010, 36 hours ahead, bond trade opens at the Tokyo stock exchange. So Trichet brought the Council to the decision that a pan-euro bailout umbrella should be established and the no-bailout clause shall not be applied any more. In fact he convinced chancellor Merkel to design the plan for such an umbrella and to assume the lion's share of the costs. President Sarkozy warned that France will leave the euro if Germany will not agree.

Finally it was agreed that a first tranche of 60 bn. euro comes from the Commission, a second tranche of 440 bn. euro from the euro member states, a last but not least tranche of 250 bn. euro should come from the IMF, in total 440 bn. euro.

The plan raised several legal problems. The first tranche of 60 bn. euro has been approved along with the balance of payment support given to Hungary, Latvia and Romania based on art. 122 para. 2 TFEU. In reality, however, these three states are non-euro states (which made a balance or payment loan feasible). A euro state, however, could not be given a balance of payment support because its balance of payment cannot become negative. Problems as this were, however, benignly neglected as has been neglected that there was no funding for such loans (see Blankart and Koester 2012). A second tranche should be provided via a private law special purpose vehicle. So it could be avoided to use the roundup Council competence of art. 352 TFEU which can only be used if a decision is made by the ensemble of all 27 EU member states which was, however, not the case as the UK wanted to stay out. In any case the special purpose vehicle was chosen for the sole reason to avoid a violation of the no-bailout clause of art. 125 TFEU. But it seems questionable whether a collective made for the explicit purpose to evade a decision which is illegal is not itself illegal. In any case the French finance minister Christine Lagarde as well as the minister of European affairs Pierre Lellouche conceded that the factual abolition of the no-bailout clause of art 125 TFEU was in contradiction of the Treaty of Lisbon. Therefore one should better talk of a coup d'état by the euro council and not of a legal decision.

Trichet's personal satisfaction was that the burden of the bailout has been distributed among all euro states. So the French principle of budget balancing won over the Maastricht principle of self-responsibility. Should one alternatively consider the bailout umbrella as an insurance scheme against government bankruptcies the burden of the contributions is not distributed in an actuarly fair way. Small high risk states such as Greece, Portugal, Ireland and Cyprus pay little or nothing while large and small low risk states such as Germany, the Netherlands and Luxemburg contribute most. These actuarily unfair premia give courage to states as Italy and Spain to postpone reforms and to become dependent of further bailouts. So the crisis has not leveled off, but it has grown along the bailout spiral from 110 bn. euro for Greece in 2010 to 2,3trillion euro overall in 2012.

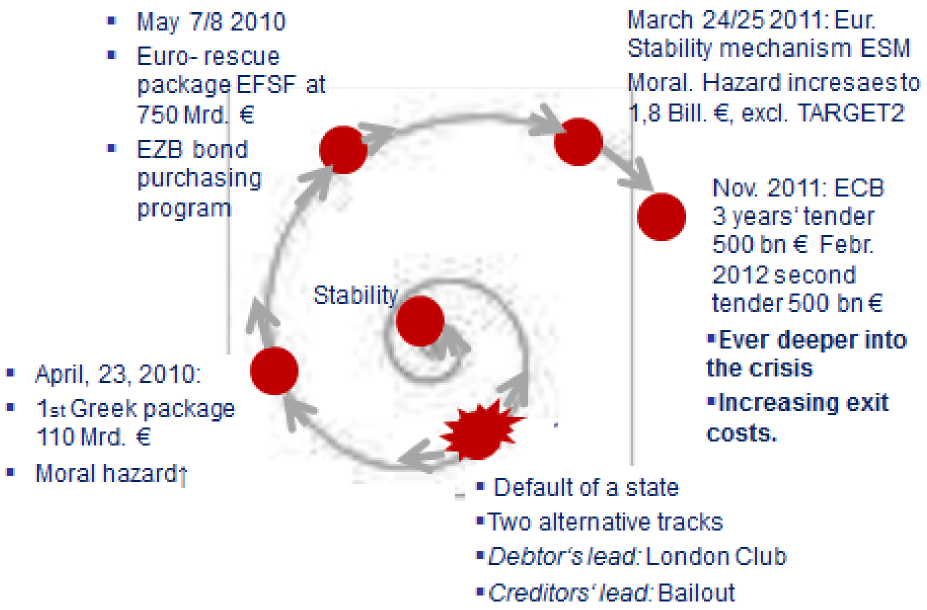


Figure 2: The euro bailout spiral 2010-2012 a graphical exposition of the euro crisis.
Source: Own composition based on ifo data

6. Conclusions and alternatives

1. Europe is in a deep economic crisis. Most economists believe that the crisis roots in a detrimental interaction between markets and governments. The conclusion is that if only the political decision makers behave differently, the crisis could be mastered. In this paper it is argued that the euro crisis is generated by the interaction of national institutions which become incompatible when they are joined in a monetary union. Therefore an institutional reform seems necessary to solve the euro crisis.

2. The paper started with a comparative analysis of the fiscal organization of postwar Germany and postwar France before the euro. Germany is characterized by bottom up budgeting with balancing and responsibility on each fiscal level. None of the fiscal entities has access to central bank money. Budget deficits must be financed over the capital markets. The Bundesbank is only responsible for price stability and not for financing the public budgets. Postwar France similarly

consists of départements which have their own budgets. But the final balance of all budgets is made on the national level. The unitary state of France is therefore characterized by longer chains of command than the federal Republic of Germany. Therefore the French fiscal organization is presumably more vulnerable to subcentral shirking and moral hazard than its German counterpart. Therefore more costs have to be carried c.p. by the French compared to the German taxpayer. In order to disguise these costs the French government relies on indirect taxes and public debt (presumably more than Germany). In particular, however, it relies on money creation over the central bank, the Banque de France. The consequences of money creation manifested themselves in periodic balance of payments deficits and subsequent devaluations of the French Franc.

3. The fiscal institutions of Germany and France are as oil and vinegar. They are viable in their national monetary systems. But put together under the common roof of the euro they become inconsistent and destructive as oil and vinegar are in quarrel as soon as they are joined in a salad bowl. The salad may be good, but it must be consumed immediately. After some time oil and vinegar separate again in two puddles one of oil and the other of vinegar and the salad has to be thrown away.

4. In separation, oil and vinegar systems can work. Individuals of the oil system can trade with individuals of the vinegar system. In separation none can exploit the other. Trade brings mutual benefits, but avoids a fiscal entity through in which the vinegar system could exploit the oil system. Moreover, if the economic fluctuations of the two countries differ a natural separation protects each other from mutual contagion.

5. A monetary union may also work if both countries are either of the oil type or of the vinegar type. If both countries follow oil with fiscal breakeven they can benefit of the common currency and there is no danger of mutual exploitation. If they are both of the vinegar type with fiscal deficits and central bank financing, they also may benefit of the monetary union (provided that their fiscal deficits are not too unequal). For if there are only deficits exploiting each other does not lead very far. Another question is whether the two suffer from symmetric economic shocks in which case contagion may become a problem and a union should be rather avoided.

6. Suppose that Germany and France join in a monetary union so that oil and vinegar are mixed. It is written in the contract that the common central bank shall abstain from financing the budgets so that both the oil and the vinegar country have to play oil. Both have to breakeven their finances (possibly with debt from the capital market). If the contract is enforced, both countries will benefit from the monetary union. The way towards compliance is, however much more onerous for the vinegar country than for the oil country. The vinegar country has to undergo a constitutional reform of its fiscal system which the oil country has nit to do. Therefore the vinegar country will try to pull the contract more into cross subsidization formerly on the national, now on the EU level. The former national vinegar model dears to become a euro wide vinegar model. Therfore the common currency only works if the *oil country (Germany) vigorously insists that the*

contract is enforced. Evidence of the destiny of the Maastricht contract, however, shows that that Germany was rather weak in this respect. The euro rules of Maastricht have been dismantled as shown in the main text above. The ECB rules have been eroded and the no-bailout clause has been abolished. Therefore we are now in a mixed system of oil and vinegar. Vinegar insists on transfer programs for the peripheral countries with the hope that they will serve its own interests when it comes in financial difficulties. Oil is increasingly exploited. Hans –Werner Sinn (2012) calculates that Germany will be liable for about 700 bn. euro if the five GIIPS states (Greece, Italy, Ireland, Portugal and Spain) will be bankrupt and that this sum increases to 1 trillion euro if the euro collapses a a whole. These are 27% or 42% of Germany's GDP (2011). This shows the destructive power of vinegar in combination with oil.

7. These liabilities imply a doubling of the tax burden for the German tax payer which is presumably beyond the constitutional limits of taxation. If Germany refuses to bear its liabilities, it will come under default and its future becomes even more difficult. At this point Germany is squeezed out and the mixture of oil and vinegar will find its natural end. A return to national currencies with oil and vinegar separated is indicated. But as Germany lacked the courage to enforde Maastricht and to stop the accumulation of liabilities, it is unlikely that it will have the energy now to stop the euro. I rather suppose that Germany (and its voters after a constitutional referendum) will be so weak that they will forsake its federal tradition and accept a pure vinegar system with common pool budget balancing in Brussels.

8. So the euro may survive. But will Europe survive? Following Jones (1987) the "European Miracle" is due to its diversity, its multicultural structure and its competition of ideas. The euro currency, however, eliminates all that. For it requires not only a federal, but even a unitary state. Therefore we may save the euro, but lose Europe.

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