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There Is an Alternative
A Two-Tier European Currency Community

Fritz W. Scharpf

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Abstract

The performance of EMU member economies is shaped by different and structurally entrenched "growth models" whose success depends on specific macro-regimes – restrictive for export-led growth, accommodating for demand-led growth. These two types of models cannot be equally viable under a uniform macro regime, and their divergence threatens the stability of the EMU. The present attempt to enforce structural convergence in the eurozone appears economically ineffective and lacks democratic legitimacy on the national and the European level. Assuming that complete integration in a democratic federal state is presently unattainable, the paper presents the outline of a more flexible European Currency Community that would include a smaller and more coherent EMU and the member states of a revised "Exchange Rate Mechanism II" (ERM) whose currencies are flexibly linked to the euro. It would restore the external economic viability of autonomous domestic policy choices, and it would protect its members against speculative currency fluctuations.

Keywords: autonomy, currency coordination, EMS, EMU, ERM, EU, legitimacy

Zusammenfassung

Die Eurozone vereint strukturell heterogene Ökonomien, die entweder auf exportbasiertes Wachstum und stabilitätsorientierte Geld- und Fiskalpolitik oder auf nachfragegestütztes Binnenwachstum und dementsprechend akkommodierende Makropolitik angewiesen sind. Unter einem einheitlichen europäischen Makroregime können nicht beide Typen gleichermaßen gedeihen und ihre Divergenz gefährdet die Stabilität der Währungsunion. Die gegenwärtigen Euro-Regeln sollen eine strukturelle Harmonisierung erzwingen, aber ihr ökonomischer Erfolg ist zweifelhaft und sie sind weder auf der nationalen noch auf der europäischen Ebene demokratisch legitimierbar. Anstatt der gegenwärtig unerreichbaren Vollendung der Integration in einem demokratischen Bundesstaat skizziert der Aufsatz das Konzept einer flexiblen „Europäischen Währungsgemeinschaft". Diese würde eine kleinere und strukturell homogenere Währungsunion mit den Mitgliedern eines verbesserten Europäischen Wechselkursmechanismus (WKM II) vereinen, deren Währungen flexibel an den Euro gekoppelt sind. Eine solche Lösung würde den Handlungsspielraum autonomer nationaler Politik erweitern und böte zugleich Schutz vor spekulativen Attacken auf die Währungen der Mitglieder.

Schlagwörter: Autonomie, EU, EWS, EWU, Legitimität, Währungskoordination, WKM

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There Is an Alternative: A Two-Tier European Currency Community

1 Background

The European Monetary Union (EMU) of 1999 originally (i.e., after the accession of Greece in 2001 and before Eastern enlargement) included economically, institutionally, and politically diverse member states that had performed as either "hard-currency" or "soft-currency" economies under the previous regime of adjustable exchange rates within the European Monetary System (EMS) of 1979. In comparative political economy, the divergence has been analyzed as a difference between structurally entrenched "growth models" (Baccaro and Pontusson 2016; Iversen et al. 2016; Johnston 2016): "Northern" economies[1] with relatively large exposed sectors have come to rely on export-led economic growth, whereas "Southern" economies[2] depended on demand-led growth in their large domestic sectors.

The economic viability of both models depended on matching wage-setting and macroeconomic policy regimes: in the North, coordinated industrial relations were capable of practicing export-oriented wage restraint while monetary and fiscal policies were constraining inflationary price increases, whereas the wage dynamics of competitive Southern industrial relations systems were accommodated by expansionary monetary and fiscal policies. But even though inflation rates diverged widely, both models were economically viable as long as exchange rates were floating or could be adjusted.[3]

After entry into the EMU, structural divergence continued, but the national growth models lost their internal coherence and their external compatibility. Since monetary policy was centralized, macroeconomic impulses could no longer respond to differing conditions in national economies. And as the exchange-rate buffer was eliminated by the single currency, low-inflation, export-oriented economies would inevitably outcompete economies relying on demand-led domestic growth (Scharpf 1991, 263–69).

1 After 1999, the Northern group included Germany (whose comparatively small export sector was rapidly increasing), the Netherlands, Austria, and Finland. Ireland, with its very large export sector, does presently conform to the Northern model, but its wage and fiscal policies were expansionary between 1999 and 2008. In the larger Monetary Union that exists today, moreover, at least the three Baltic member states and Slovakia have also adopted the practices and political preferences of export-oriented economic growth.

2 Originally, the group included Greece, Italy, Spain, and Portugal, with France and Belgium in an ambivalent position, and with Ireland as a temporary member during the first decade of the Monetary Union.

3 Between 1969 und 1988, for instance, cumulative economic growth reached 72 percent in soft-currency Italy as compared to 55 percent in hard-currency Germany (Scharpf 2018, Table 1).

After 1999, the structural effect was reinforced by the decline of nominal interest rates to low German levels, fueling credit-financed demand expansion in the South, whereas German wages and demand were further constrained by high real interest rates in a deep recession. Hence, the first decade of EMU was characterized by the dynamic divergence of economic trajectories and the dramatic rise of external imbalances – with domestic growth and rising external deficits in the South and domestic stagnation and rising external surpluses in the North. But when interbank lending came to a "sudden stop" during the worldwide financial crisis of 2008–09, externally over-indebted Southern economies were in deep trouble. Banks were collapsing, and when governments came to their rescue, public-sector debt escalated and some exposed states were then (and only then!) faced with challenges to their liquidity and ultimately, solvency – which was then treated as a euro crisis.

If the no-bailout rules of the Maastricht Treaty had been followed in May of 2010, Greece would have had to declare insolvency and perhaps leave the Monetary Union. Other Southern member states might have followed – which would have allowed them to correct distorted real exchange rates and to restore macroeconomic cohesion on the national level. At the same time, structural divergence would have been greatly reduced among the remaining eurozone economies, which would have improved the goodness-of-fit between European Central Bank (ECB) policies and national economic conditions. But that is water under the bridge. Instead, the euro was saved through intergovernmental rescue credits, combined with deeply intrusive and tightly controlled "conditionalities" imposing fiscal austerity and supply-side structural reforms, on Greece and other "program states."

2 Hierarchical coordination, enforced convergence, and a lack of legitimacy

Ever since the spring of 2010, rescuing the euro has been the absolute priority of European-level decision-makers in the Commission, the ECB, the European Court of Justice (ECJ), and the European Parliament (EP) – as well as of national governments in the European Council and the Eurogroup. But given the continuing structural divergence of eurozone economies, the pursuit of that overriding goal implied not only fudging the Maastricht rules, but also violating the allocation of European and national competences in the Treaties and the basic principles of democratic accountability at national and European levels.

From rule-based governance to discretionary hierarchical coordination

The Maastricht Treaty had created an "incomplete monetary union" (De Grauwe 2013a), which was based on the presumption that the no-bailout rules, the prohibition of monetary state finance and the deficit and debt rules of the Stability Pact would suffice to achieve the necessary coordination between centralized monetary and exchange-rate policies and national fiscal and regulatory policies. This belief, derived perhaps from monetarist economics or ordoliberal principles, was theoretically naïve (Thompson [1967] 2003, 54–56; 59–65): the efficiency of coordination through general rules presupposes that these will apply to essentially identical cases under essentially invariant external circumstances. It should have been clear, even in 1992, that an EMU including hard- and soft-currency economies exposed to the turbulent environment of international markets could not be governed by fixed and general rules. What would have been functionally required instead was either the complete centralization of all macroeconomic governing functions on the European level, or the establishment of a legitimate European authority and effective capacity for (discretionary!) hierarchical coordination of the fiscal and regulatory policies exercised by democratically accountable national governments.

In the early 2000s, for instance, a hierarchical coordinator might have required Germany to ignore EMU deficit rules and to fight its deep recession with fiscal reflation; and regardless of their balanced budgets, it would have ordered Spain and Ireland to fight housing booms through fiscal retrenchment and regulatory interventions. In short, given the heterogeneity and contingency of economic challenges, what would have been needed was the transfer of sovereignty to a *gouvernement économique* with the authority to impose discretionary and discriminatory requirements on the exercise of governing powers which, under the allocation of European and national competences in the EU Treaties, are retained by the member states. Such an authority would be completely anomalous in any of the existing constitutions of democratic federal states, and its establishment was also out of the question at the time of the Maastricht Treaty.

Nevertheless, a hybrid form of hierarchical coordination was in fact established in response to the euro crisis. Once it was clear that Grexit should be avoided, the crucial first step was the decision that, regardless of the no-bailout rule,[4] rescue credits provided by eurozone member states (rather than by the EU) should be used to avert insolvency in the Greek financial crisis. That had the immediate effect of creating an asymmetric power constellation in which creditor states insisted on – and debtor states had to comply with – credit conditionalities; and it established intergovernmental bargaining in the arena of the

4 It has been suggested that fudging the Maastricht prohibition of monetary state finance might have been more effective than fudging the no-bailout rule (De Grauwe 2013b). Indeed, if the ECB had been able to act as a lender of last resort for member states, Draghi's "whatever it takes" might have capped speculative spreads of Southern bonds in 2009–2010 as effectively as it did in 2012. But could it also have defined and enforced conditionalities?

informal Eurogroup as the dominant mode of policy making. Under the authority of the Eurogroup, then, the Commission did specify detailed "Memoranda of Understanding" which, under the threat of state insolvency, were to be signed by governments of recipient "program states." Performance was to be controlled by a "Troika" of Commission, ECB, and IMF (International Monetary Fund) officials, on whose assessment of effective compliance the release of the next installment of a rescue credit would depend.

This system allows the Commission to define and enforce country- and situation-specific and highly detailed policy directions across the full range of national governing functions. But since this extremely powerful form of hierarchical coordination depends on applications for rescue credits by individual states in acute financial crisis, it cannot stabilize the Monetary Union through preventive coordination. Nevertheless, it was a model, and it continues to be a worst-case backstop for the general euro regime established after 2011 through the Six-Pack and Two-Pack legislation and the intergovernmental Fiscal Compact (Scharpf 2011; 2016).

The Excessive Deficit Procedure and the Fiscal Compact have tightened the fiscal rules of the original Stability Pact by requiring structurally balanced national budgets and the progressive reduction of accumulated public sector debt. Under the new Macroeconomic Imbalances Procedure, moreover, the Commission has defined upper and lower thresholds for external balances, wages, prices, and a wide range of other economic and financial indicators – all of which are designed to constrain the rise of domestic demand, wages, and other factors that might impede export competitiveness. Finding a member state to be in "excessive deficit" or "excessive imbalance," the Commission can specify corrective measures that may be made legally binding and may ultimately, in case of non-compliance, be enforced through severe financial sanctions.

Enforced structural transformation toward the Northern model

In substantive terms, the euro regime amounts to a eurozone-wide generalization of the conditionalities imposing fiscal austerity and internal devaluation on Greece and other program countries after 2010. Given that these countries were struggling with a deep recession, these requirements were obviously deepening the crisis – and hence perverse from the perspective of Keynesian economics (Krugman 2012; 2013; Stiglitz 2016). They appear less irrational, however, if we assume that the regime is trading the short-term recovery of individual economies for the longer-term stability of EMU (Scharpf 2016): if euro crises are seen to arise from structural divergence and external deficits, then stabilization must achieve a structural transformation of Southern economies toward the Northern model of export-led economic growth. To that end, fiscal austerity must not merely reduce current external deficits, but should shrink oversized domestic sectors. And wage repression must not merely improve short-term competitiveness, but should increase the relative size of the export sector.

But capital and labor could not simply be shifted from the domestic sector to export production. Hence fiscal retrenchment did not only require painful cutbacks in public-sector employment and welfare-state functions, but also had to produce massive job losses in the domestic economy that were only partly compensated by the greater competitiveness caused by wage cuts in the small export sectors. In the short and medium term, therefore, attempts to enforce structural transformation did entail very high social and economic costs in Southern political economies. Ten years after the onset of the euro crisis, changes in the intended direction have indeed taken place. Southern current accounts are no longer in deficit; unit labor costs have been dampened; and exports are growing faster than GDP. Yet overall employment is still significantly lower and public-sector debt much higher than it was at the height of the crisis. Worse yet, the competitiveness gap has not been closed, since the further increase of German export surpluses has exceeded the decline of Southern deficits (Scharpf 2018, Table 3). For structural transformation to succeed, in other words, fiscal austerity and enforced structural reforms would need to be extended and intensified.

The euro regime's lack of democratic legitimacy

In fact, however, enforcement seems to have been weakening for some time. The ECB's unconventional monetary policy and the Commission's "political" discretion in enforcing deficit rules have been softening the impact of fiscal austerity on Southern economies (V. Schmidt 2016). And as beliefs in the present regime's problem-solving effectiveness have been weakening, its justification by a common interest in stabilizing the euro is increasingly undermined by the glaring injustice of its distributive impacts: If the euro must be defended, why should all the burdens and sacrifices have to be imposed on Southern political economies?

Obviously, this distributive conflict affects the legitimacy of the present regime; and obviously it cannot be democratically resolved on the national level, where autonomous political choices must necessarily be disabled by any effective system of hierarchical coordination. On the European level, however, the government of the eurozone is institutionally shielded against democratic accountability to the constituencies affected by its impact (Zeller 2018). The immediate responses to the euro crisis had been adopted by eurozone governments in the European Council and in the Eurogroup of the ECOFIN Council without participation of the European Parliament (EP). And although the Six-Pack and Two-Pack regulations (but not the Fiscal Compact) were subsequently established through European legislation, the EP's role was marginal.

Apart from the increasing involvement of the ECB, therefore, substantive policies, procedures, and specific measures under the present euro regime continue to be determined in intergovernmental negotiations on the Summit level and in the Eurogroup, whereas rules are enforced by the European Commission, and actual rescue programs are implemented by the intergovernmental European Stability Mechanism (ESM). Assuming that national leaders and finance ministers are responsive to the preferences of their respective parliaments and voters, it is claimed that intergovernmental decisions are legitimated by democratic accountability on the national level. For the euro regime, however, that claim is false. National agents may indeed be authorized by national constituencies – but only to agree to general rules that will also bind their own states, and to special sacrifices that affect their own country.

Hence the German, Dutch, or Finnish parliaments could authorize their finance ministers to agree to budget-based rescue credits, but they could not legitimately impose highly intrusive and extremely burdensome sacrifices on Greece or Portugal. These depended therefore on the agreement of Greek and Portuguese prime ministers to credits with extremely harsh conditionalities that were defined and imposed by creditor states under the threat of immediate state bankruptcy. Under these conditions, subsequent parliamentary acceptance under duress could certainly not amount to democratic legitimation. Moreover, the same asymmetric intergovernmental bargaining constellation between potential (Northern) donor states and potential recipients has also shaped the substantive rules and enforcement procedures of the present euro regime. In the adoption of the present euro regime, the European Parliament played only a marginal, and in effect asymmetry-enhancing, role that could not be construed as democratic legitimation on the European level (Warren 2018). In effect, it is inconceivable that this regime could have been adopted after full debate in a parliament that was politically responsive to constituents throughout the European Union.

Alternatives within the EMU: Symmetrical transformation or burden sharing

Given the glaring asymmetry of the convergence regime, which fits with Northern economic and institutional structures and interests and imposes all sacrifices and burdens of adjustment on Southern political economies, not only Southern governments and publics but also a few German economists have been denouncing persistent German surpluses as the main cause of EMU problems (Flassbeck and Lapavitsas 2013; Bofinger 2015). In their view, a viable euro regime must also ensure that domestic demand and production costs in Germany will rise in line with eurozone averages. And even the Commission, which initially treated surpluses as a lesser problem (Commission 2012), began to prod Germany in 2014 and intensified its admonitions as surpluses continued to increase year after year (Commission 2014; 2015; 2016). But it did so without ever invoking the sanction-backed "corrective arm" of the Macroeconomic Imbalances Procedure, and it did not provide sufficiently specific and practicable recommendations that a compliant German government could simply have adopted (Scharpf 2018).

One reason is, of course, German political resistance – which, however, reflected not only dogmatic disagreement or bloody-minded bargaining, but also a lack of government capacity: to reduce German exports, industrial wage settlements would have to significantly exceed inflation- and productivity-adjusted levels – which the government could not impose directly, and which unions could not realize under the constraints of industrial outsourcing. If instead the goal was to increase imports, the government was again powerless to affect private demand for investments and consumption directly. And quite apart from any balanced-budget preferences, the peculiar constellation of joint-decision fiscal federalism would not allow the national government to increase domestic demand unilaterally, through tax cuts or significant increases in public investment and public-sector employment (Scharpf 2018). In any case – and not only in Germany –, demand expansion is much more difficult to prescribe and to enforce than demand contraction.[5]

Possibly in response to such insights, structural convergence, whether addressed to Southern or Northern economies, seems to have lost the headline status it had in the *Five Presidents' Report* (2015). Instead, present initiatives aim at the better management of financial and fiscal risks in the eurozone. Thus the Commission's *Reflection Paper on the Deepening of the Economic and Monetary Union* (Commission 2017) focuses on the completion of the Banking Union with a common deposit insurance and a fiscal backstop for bank resolution funds, on a Capital Markets Union that should increase risk dispersion in the private sector, and on the creation of a "Fiscal Union" with financial capacities for anti-cyclical intervention and automatic stabilizers.

These proposals take pains to deny any implication of a transfer union, invoking instead a common interest in risk dispersion and mutual insurance against asymmetric shocks – for which the structural heterogeneity of eurozone economies is not seen to matter: if the EMU were to fail, "it may not be because of diversity and inequality of its members … but because of the limited capacity to share and diversify risks" (Schelkle 2017, 1). Strictly speaking, however, an insurance argument relying on the "generalized and reciprocal self-interest" of EMU member states (Schelkle 2017, 314) must logically presuppose the random incidence of future shocks. If risks should in fact be skewed as a consequence of persistent structural divergence, risk sharing would turn into burden sharing – which would then need to be justified by arguments invoking redistributive solidarity rather than rational self-interest. Backed by appeals to "French-German friendship" and moral commitments to European integration, such proposals may well succeed in Germany (though perhaps not among its Northern and Eastern allies). But there are two caveats:

On the one hand, all solutions which – like the initial rescue credits – are framed as burden sharing will re-create an asymmetric "donor–beneficiary" constellation, where suspicions of moral hazard are again likely to imply constraining conditionalities and

5 This is, of course, not meant to deny the extreme vulnerability of the German model to external economic or political changes that would reduce global demand for the products of its over-extended export sector.

intrusive controls rather than the empowerment of national choices. On the other hand, risk sharing would at best compensate the victims of future crises, but it would not itself reduce the unequal probability of asymmetric shocks occurring in structurally divergent eurozone economies. Hence, if the EMU is to be stabilized, rules and controls to enforce (Southern or Northern) structural transformation would still be needed – and thus the democratic deficit of hierarchical coordination would persist as well.

3 A non-catastrophic alternative to EMU: The European Currency Community

To summarize: in the incomplete European Monetary Union, member states have lost the option of an autonomous macroeconomic regime, but they remain responsible for all other policy instruments that interact with macroeconomic performance. In fact, however, the performance of EMU's heterogeneous member economies is shaped by different "growth models" whose success depends on specific macro-regimes – restrictive for export-led growth, accommodating for demand-led growth. These models cannot be equally viable under a uniform macro regime of the EMU. In response to the euro crisis of 2010, European policy makers have attempted to enforce a general convergence on the export-led growth model. Given its enormous economic and social costs and its lack of democratic legitimacy, however, this attempt is unlikely to reach its promised goal of stabilizing the EMU and ensuring the economic prosperity of its member states. Other options within the framework of the present EMU also appear unpromising.

To escape from this malaise, pro-European idealists put their hopes on "failing forward" (Jones et al. 2016) – from the disaster of an incomplete Monetary Union toward the creation of a European state with the redistributive capacities of a large budget and centralized competences to define and implement common economic, social, and tax policies (Guérot 2016; Hennette et al. 2017a; 2017b). If such ideas are considered undesirable or presently infeasible, however, critics should also explore options that would take a step back from rigid monetary integration in order to allow member states to opt for more political autonomy in the choice of macroeconomic regimes.

In the following sections, I will sketch the outlines of a two-tier European Currency Community (ECC) that would include a smaller and more coherent EMU and the member states of a revised "Exchange Rate Mechanism II" (ERM) whose currencies are flexibly linked to the euro. The ECC would avoid uncontrolled and economically unwarranted currency fluctuations among European political economies while allowing ERM governments to pursue autonomous domestic policies under exchange rates that ensure the viability and external balances of their economies.

Adjustable exchange rates as a precondition of political autonomy

In comparison to the postwar environment of "embedded liberalism" (Ruggie 1982), globalized product and capital markets have reduced the capacity of territorial states to shape their own economies and societies. Political autonomy is even more severely curtailed, however, by a centralized monetary regime that must enforce the structural transformation of domestic political economies. In this regard, EMU is even more constraining than the gold standard of the 1920s, whose abolition Karl Polanyi ([1944] 2001, 262) had considered a necessary precondition of democratic political choice:

> With the disappearance of the automatic mechanism of the gold standard, governments will find it possible … to tolerate willingly that other nations shape their domestic institutions according to their inclinations, thus transcending the pernicious nineteenth-century dogma of the necessary uniformity of domestic regimes within the orbit of world economy.

Under adjustable exchange rates, countries remain internationally viable as long as they are able to maintain balanced external accounts[6] – which may be attained by economies with small or large export shares. In order to pay for their imports, countries must maintain an attractive export portfolio and appropriate exchange rates, but they are not compelled to rely on export-led growth overall. Instead, the adjustment of exchange rates may buffer domestic institutions and policy choices against the homogenizing impact of globalized markets. Even with capital mobility, nation states are not compelled by economic globalization to subject their sheltered sectors and their public and social services to efficiency-increasing market disciplines; and they are not constrained to accept ever-increasing domestic inequality in order to maintain or increase the international competitiveness of their exposed sectors (Mitchell 2015; Mitchell and Fazi 2017).

Choice and trade-offs

Quite apart from issues of technical feasibility, however, the attempt of EMU member states to recover political autonomy by a return to adjustable exchange rates would not amount to a free lunch. As has been repeatedly noted (e.g., Stiglitz 2016, 292–93), exit from the EMU would be technically easiest for Germany (and perhaps its export-oriented Northern allies), and it also would be economically most beneficial for the rest of the eurozone. The unwelcome immediate effect would be a significant revaluation of the national currency. In theory, however, the crisis of German exports might also create a window of political opportunity for more egalitarian policy choices. Potentially, a politically stable and economically sophisticated left-of-center government might counteract the job losses caused by the rise of the exchange rate, not through intervention in currency markets (as Switzerland did in a similar predicament), but through

6 Balance-of-payments crises may be averted through capital inflows – but these may be unstable.

expansionary monetary and fiscal policies. These policies would moderate the decline of employment in export industries, and they could at the same time increase domestic demand, investments, and employment in the sheltered sector of the economy – with a special place for public investments and publicly financed social services.

Unfortunately, however, this optimal solution for both the eurozone and Germany appears utopian. Quite apart from the weakness of the political Left, the fundamental ideological commitment of mainstream German politics to European integration and the political hegemony of export industries and unions will rule out the possibility that Germany could question its own membership in the Monetary Union. Hence, if the political straightjacket of the single currency is to be loosened at all, the challenge would have to be launched by Southern member states, whose economies cannot succeed under the pressure of Northern competitiveness.

For them, however, greater political autonomy will, at least initially, imply currency devaluation: this will improve the balance of trade by increasing the price competitiveness of exports and reducing the attractiveness of imports – but as import prices increase, real wages will of course decline. Once the external balance is restored, such states could then pursue domestic policies that fit the structure of their own economies. That presupposes, however, that the fall of real wages will not be counteracted by a steeper rise of nominal wages. Otherwise, wage inflation would nullify the competitive gains, and currency speculation might then trigger an uncontrollable wage inflation/devaluation spiral. In other words, the management of devaluation would be politically very demanding even if exit itself were unproblematic, which it definitely is not.

The fear of transition

In actual fact, Southern governments and publics have until recently avoided questioning their membership in the Monetary Union, even though protests against an oppressive regime and the loss of democratic self-government have erupted in all program countries. The most plausible explanations are irreducible uncertainty and terrifying predictions of financial, economic, and political catastrophes. As EMU membership was meant to be irreversible, there is no lawful exit option; there are no predefined procedures for the transition to a national currency; there are no rules for the treatment of euro-denominated private and public debt; and there are no assurances regarding the future status of the country and its currency in relation to the EMU and to the European Union.

But a practicable and fair exit regime could be created. It should allow EU member states to choose between the economic and political advantages and disadvantages of membership in the present EMU and the benefits and risks of greater autonomy and adjustable exchange rates offered by membership in a revised version of the presently existing Exchange Rate Mechanism II. At the very least, such a regime would have to achieve two purposes. It would have to regulate the procedures of consensual exit from EMU without imposing prohibitive conditions. And it would have to adjust the rules and practices of ERM II in such a way that it would support the external viability of political economies with diverse structures and political priorities.

Rules facilitating exit from EMU

The most important benefit of an exit regime would be its formal legality. Once exit is no longer an act of insurrection, but one of the legitimate choices of member states, horror mongering may give way to political debate, and market responses may be less chaotic than anticipated. Beyond that, the regime would have to include procedures for the settlement of euro-denominated external debt. Over-indebted states should be able to rely on fair and effective rules for debt restructuring. At present, such rules are not in place in the eurozone or internationally, but it should be possible to adapt existing proposals developed on the international level and in the literature (International Law Association 2010; Busch and Matthes 2015). It would be desirable, moreover, to avoid extended, Brexit-type bargaining over the transition to national currencies and the conditions of financial and procedural support. Even though full standardization may be impossible, it would still be desirable to construct a small set of pre-defined "exit models" with well-balanced rules for different types of problem constellations. While I lack the competence to propose specific solutions, reputed and knowledgeable economists of very different theoretical and political persuasions appear to be quite sanguine about the availability of practicable options that would reduce the transition costs of a cooperatively managed "amicable divorce" (Mitchell 2015, 390–421; Stiglitz 2016, chap. 10; Sinn 2014; 2015, 480–92; 2016, 306–9; but see Scott 1998).

In any case, however, countries like Greece would require support in the transition to autonomy. This was explicitly acknowledged by the German finance minister in the "non-paper" of July 10, 2015, that suggested the possibility of Grexit (described as a "time-out" from EMU membership). It proposed that

> the time-out solution should be accompanied by supporting Greece as an EU member and the Greek people with growth enhancing, humanitarian and technical assistance over the next years.[7]

The size, form, and conditions of such support would of course have to be negotiated. Nevertheless, its purposes are well identified in the paragraph cited: technical support would be needed to facilitate the installation of a new currency, and humanitarian sup-

7 http://www.sven-giegold.de/wp-content/uploads/2015/07/grexit_bundesregierung_non_paper_10_juli_2015.pdf.

port would have to assist the rebuilding of minimal public and social services in areas where they have been devastated by austerity requirements. However, the third item, "growth enhancing assistance," requires some comment.

In an earlier paper (Scharpf 2016), I argued against proposals amounting to a "transfer union" that would ease the burdens of Southern adjustment in the context of continuing EMU membership: by relaxing the demand constraints of the present euro regime, transfers would counteract the purposes of structural transformation; and as long as competitiveness is not restored, subsidies to private investments would not induce sustained economic growth. Hence, moral appeals to European solidarity would be undermined by expectations of economic futility. But if competitiveness and the profitability of investments were to be restored through nominal devaluation, the availability of external financial support may play the same positive role for economic recovery that the U.S. Marshall Plan played in postwar German reconstruction after a massive devaluation of the deutsche mark in 1949 (Scharpf 2018). In other words, moral appeals to solidarity and burden sharing invoking a common responsibility for the ill-designed Monetary Union (e.g., Ferrera 2016; Tsoukalis 2016; Stiglitz 2016) would at least cease to be economically counterproductive.

An ERM that avoids the design faults of the European Monetary System

Equally important for countries considering exit options would be the conditions of their future relations with the EMU. Even if their membership in the European Union were ensured, there would be worries about the post-exit fate of their economies. They would have to cope on their own with turbulent global capital markets. Speculative exchange-rate fluctuations might wreak havoc on the viability of industries that are closely integrated in European markets, and they might also trigger vicious price/wage/devaluation spirals that could overwhelm all national efforts at stabilization. With regard to these fears, however, promising solutions can be derived from a re-examination of the achievements and the deficiencies of the monetary regime that preceded the EMU.

In 1979, the European Monetary System (EMS) had established an Exchange Rate Mechanism (ERM) for the management of fixed but adjustable exchange rates. In cases of temporary imbalances or speculative attacks, central banks were obliged to defend exchange rate corridors by intervening in currency markets, whereas persistent imbalances were to be corrected through agreed-upon realignments. In its first decade, the EMS had been reasonably successful in helping to reduce inflation rates and currency fluctuations among its member economies. And until exchange rates were more rigidly fixed in the late 1980s, realignments had also prevented the rise of persistent trade imbalances (Artis and Taylor 1993).

The regime was institutionally vulnerable, however, because it lacked a central bank that was committed to the common interest. As exchange rates were defined pairwise between all national currencies, the Bundesbank, in charge of the largest and hardest currency, played a dominant role in all adjustments. Moreover, it had been allowed to insist – in the (in)famous "Emminger letter" to Chancellor Schmidt (Tietmeyer 2005, 79–80) – that it would not be required to compromise its basic commitment to price stability in the German economy. As a result, interventions in currency markets were less effective – and currency realignments were more frequent – than they otherwise would have been. These adjustments had to be achieved through controversial and typically belated intergovernmental bargaining (Marsh 2009), in which revaluations were in fact more frequent than devaluations (Höpner and Spielau 2017). In September of 1992, finally, when the Bundesbank had clamped down on the German post-unification boom and also refused to intervene in support of the British pound, rampant currency speculation ejected the UK and Italy from the EMS and triggered a deep crisis in Sweden. In effect, then, the Bundesbank destroyed the EMS and, by the same token, made completion of the Monetary Union politically inevitable (Padoa-Schioppa 1994; Marsh 2009).

The most critical design faults of the EMS were corrected in the Exchange Rate Mechanism (ERM II) which, at the start of the Monetary Union in 1999, replaced the EMS for EU member states outside the euro area (ERM Agreement). It differs from the ERM I in two crucial respects: the ECB retains its role as the central bank for the system as a whole,[8] and the agreed-upon "central exchange rate" of a member currency is defined in relation to the euro, rather than in a network of bilateral rates among all currencies.[9] Under ERM II rules, currencies are presently allowed to fluctuate up to 15 percent above and below their central rate. In contrast to Bundesbank practices under the EMS, the ECB's "intervention at the margins shall in principle be automatic and unlimited" (Article 3.1, ERM Agreement 2006).[10] But the ECB may also agree with a national central bank on coordinated intra-marginal intervention and other adjustment measures (Article 4, ERM Agreement 2006).

Significantly, moreover, the authorizing Resolution of the European Council had insisted that "convergence of economic fundamentals is a prerequisite for sustainable exchange-rate stability" (para 1.1, Resolution 1997). Hence, stabilizing interventions

8 All central banks of EU member states are parties to the ERM Agreement, but participation in the ERM II is voluntary for non-euro area member states.

9 Central exchange rates and their adjustment are to be set by "common procedure" (Article 1.1 ERM Agreement 2006) requiring "mutual agreement of the ministers of the euro-area Member States, the ECB and the ministers and central bank governors of the non-euro area Member States participating" in the ERM. Moreover, "all parties to the mutual agreement, including the ECB, will have the right to initiate a confidential procedure aimed at reconsidering central rates" (para. 2.3, Resolution 1997).

10 In a bow toward the Bundesbank's "Emminger letter," Article 3.1 also allows the ECB to suspend automatic intervention if this were to conflict with its commitment to price stability. But given the relative sizes of the euro and a single ERM currency, that condition is unlikely to arise.

should indeed protect ERM states “from unwarranted pressures in the foreign-exchange markets” (para 1.3, Resolution 1997), but the designers of ERM II also realized that “sticky” exchange rates may deviate from fundamentals. Therefore, it also “should be ensured that any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments” (para 1.5, Resolution 1997).

Toward a two-tier European Currency Community (ECC)

In practice, however, the ERM II has been less flexible than its rules suggest. With the exception of Denmark, all its member states were (ultimately successful) candidates for full EMU membership – and were held tightly to the accession criteria. Hence, while there have been a few instances of currency revaluation, the Commission and the ECB did refuse to allow the currency devaluations that had been recommended by the IMF during the turbulence of the 2008–09 international financial crisis (Lütz and Kranke 2014). But although the practice of prioritizing exchange-rate fixity would have to change, existing ERM II rules would hardly need to be amended to serve the purpose of organizing the relations between the EMU and European states whose currencies should remain flexibly linked to it.

If that were accepted, European currency relations might eventually evolve into a two-tier community, centrally managed by the ECB, and with two types of members: those remaining in or joining the EMU, and those operating under ERM rules. The EMU tier is likely to include states whose economic structures and political preferences are compatible with the present euro regime, whereas the ERM group might include members whose economies are structurally incompatible with the euro regime, but also others whose preferences for political autonomy would conflict with a compulsory euro regime.

For *members remaining in the EMU*, the exit of Southern economies might entail a revaluation of the euro – whose effect the ECB could mitigate by selling euros in the currency markets. Beyond that, reduced structural divergence among member economies would increase the goodness of fit and effectiveness of uniform ECB monetary policy, and it would also facilitate closer coordination of European monetary policy with national fiscal and economic policies. Moreover, the elimination of North–South conflicts and greater economic coherence might facilitate progress toward political integration. In that case, it might even be possible to move away from policies adopted in the mode of intergovernmental bargaining in the Eurogroup (where vetoes are stabilizing the present hard-currency regime) toward some form of majoritarian euro government that might perhaps resemble the “T-Dem Treaty” suggested by a group of French authors (Hennette et al. 2017a; 2017b). With greater governing capacity and more democratic legitimacy, such governing institutions might then also be able to choose from a wider range of macroeconomic options.

The *membership of the ERM*, by contrast, would not have to be economically coherent and structurally convergent, and the regime's dominant purpose should not be to maximize exchange-rate fixity – which would be incompatible with autonomous macroeconomic policy choices on the national level. Instead, the revised ERM should help its members to trade in European markets under nominal exchange rates that reflect the underlying fundamentals of their economies, and to protect these economies against "unwarranted pressures in the foreign exchange markets." That presupposes, of course, that the central euro exchange rates of EMR currencies are appropriately set to begin with – e.g., by reference to intra-European trade balances and/or the country's real effective exchange rate (REER) based on intra-European exchanges.

Member states would then have to use their domestic policy instruments to keep actual rates within the standard fluctuation band – which (at plus or minus 15 percent) would be much wider than in the EMS. And if they nevertheless approached its limit, they would be supported by the ECB's automatic intervention at the margins. The margins could be exceeded, and economic fundamentals could change, however, not only through domestic or external economic shocks, but also through major changes in domestic policy choices. As was the case under the postwar Bretton Woods regime,[11] both types of changes should then be accepted as justification for an adjustment of the central euro exchange rate. Once adjusted, however, the management of ERM currencies may still be challenging.

This is obvious in the case of devaluation. If the rise of import prices and the decline of real wages were compensated by wage increases, the new exchange rate could not be stabilized, and the currency might enter a downward slide. Where devaluation did in fact succeed, as in Sweden in the early 1980s (Scharpf 1991, chap. 6), stabilization was supported by voluntary union wage restraint. In non-cooperative Southern industrial relations systems, however, success may well depend on compensatory "political exchange" (Pizzorno 1978). While such deals are being negotiated, downward speculation may trigger a devaluation/inflation spiral that might become uncontrollable even before the ECB's automatic intervention sets in at the −15 percent margin of the fluctuation band. Hence coordinated intra-marginal intervention (Art. 4, ERM Agreement 2006) may be essential for stabilizing a currency after devaluation. Similarly, ERM countries with internationally attractive currencies might also face economically unwarranted revaluation pressures, and thus could also benefit from intra-marginal coordination with the ECB.

In short, the present rules seem well designed for maintaining agreed-upon central exchange rates and fluctuation bands against external pressures. But the ERM may also need to deal with the opposite problems of member states resisting the adjustment of

11 Under the Bretton Woods regime of pegged exchange rates, the IMF had to accept exchange-rate changes to correct a "fundamental disequilibrium," and it could not oppose adjustments on the grounds that domestic social or political policies of the country had caused the disequilibrium that made the change necessary (Ruggie 1982, 396).

over-valued or under-valued nominal exchange rates. The first case, which would improve the country's terms of trade, is probably self-defeating, since it would also entail external deficits and balance-of-payments crises. Persistent under-valuation, however, is not self-correcting. It allows a country to accumulate export surpluses that must be matched by the aggregate deficits of its trading partners. The problem has become severe in the Monetary Union, but even under Bretton Woods and the EMS, the under-valuation of the deutsche mark had facilitated German export surpluses (Scharpf 2018; Höpner 2018; Höpner and Spielau 2017).

Compared to Bretton Woods and the EMS, however, the problem of under-valuation is mitigated in the ERM by the much wider fluctuation band that would allow a 15 percent upward float of the nominal exchange rate. Beyond that, ERM rules require the timely adjustment of central exchange rates "so as to avoid significant misalignments" (para 1.5, Resolution 1997). And unlike the IMF under Bretton Woods, the ECB is not limited to accepting or denying adjustments requested by member states; it may also "initiate a confidential procedure aimed at reconsidering central rates" (ERM Agreement 2006, 1, last bullet point).

In sum, therefore, a reactivated and slightly modified ERM would not have to reproduce the deficiencies of the EMS. It could help to stabilize nominal exchange rates reflecting economic fundamentals and thus to protect the intra-European competitiveness and external balances of its member economies; it would provide powerful defenses against speculative attacks on individual member currencies; and it would also be able to facilitate the coexistence of structurally diverse economies and of member states with divergent political priorities.

4 Conclusion

Recent events have been a reminder of the continuing fragility of a rigid monetary union with structurally divergent member economies. If it is understood that, for economic and political reasons, enforced structural convergence cannot be the answer, that current proposals for risk and burden sharing are likely to perpetuate the divergence, and that full political integration is beyond reach for the time being, then basic alternatives should be worth considering.

In this paper I have sketched the outlines of a two-tier European Currency Community that would combine a smaller and more coherent EMU with a revised ERM whose member currencies are flexibly connected to the EMU. Its purpose is to avoid uncontrolled and economically unwarranted currency fluctuations among European political economies while allowing ERM governments to pursue autonomous domestic policies under exchange rates that ensure the viability and external balances of their economies.

These conditions might be attractive not only for Southern member states hoping to improve their economic prospects by leaving EMU, but also for countries like Sweden or Poland with competitive economies and a preference for greater political autonomy. In effect, therefore, the ECC might operate as a "euro block" that is larger and even stronger than the present EMU in international and global financial negotiations. Even more important, however, would be the political benefits: by accommodating the structural and political divergence of European political economies, the ECC could unlock capacities for European cooperation and political action that are presently paralyzed by the need to suppress the politically unmanageable North–South conflict.

A note on implementation

It is unreasonable to expect that the European Union in its present shape, and with the current problem load on its political agenda, might soon agree on an explicit commitment to create a two-tier European Currency Community. But neither would that be necessary. It would suffice to create the minimal institutional opportunity structure for evolutionary processes driven by self-selective national choices and by subsequent political pressures for their accommodation. The first step might even be uncontroversial: it would merely require a political declaration reminding governments, the ECB, and the Commission that membership in the ERM II is available for all non-eurozone states, regardless of whether they intend to subsequently apply for EMU membership. The second step would require an amendment to the Treaty creating the possibility of voluntary exit from the EMU under conditions to be specified by European legislation. Taken together, these steps might suffice to launch national and European debates and policy initiatives that, eventually, might bring about a less constraining and counterproductive European regime of economic coordination and cooperation.

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