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The logic of one currency only having one finance minister

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'The eurozone needs to significantly step up its efforts to fight the crisis. This ultimately will require the creation of a true eurozone finance ministry with tax-raising powers'

Following the summit on the fate of the euro area on December 9, and this after a long series of summits in 2011, we should expect a large number of further summits in 2012. Indeed, the euro area faces severe challenges, with a break-up of the monetary union now being openly discussed.

The ongoing crisis clearly exposes the failure of the Maastricht architecture for Economic and Monetary Union (EMU). Central to this failure is the lack of any fiscal capacity for the euro area. The EMU architecture must be strengthened by taking steps towards a fiscal union that involves both a political authority (a Euro-area finance minister) and fiscal resources to prevent, manage and resolve crises.

The euro area faces three major challenges. First, it is confronted with very high private and public debt levels in some of its parts. This debt is not only domestically held but in Spain, Portugal and Greece constitutes debt owed to creditors outside of the country of above 80 per cent of GDP.

Repaying external debt while at the same time being obliged to reduce prices to become competitive and export more to repay for the external debt is extremely difficult. In fact, historical lessons show that even the external interest burden can become difficult to shoulder. (John Maynard Keynes has written extensively about the problem of external debt payments at a different time and in a different context and his lessons remain valid to date.)

Second, stress tests by the European Banking Authority have not restored trust in the eurozone banking system. More worryingly, the eurozone banking system currently lacks a credible fiscal lender of last resort. National finance ministries alone cannot credibly prevent deposit runs or withdrawals of funds from banks located in their country as they are too small and may lack access to markets to borrow at good rates. We have seen the build-up of such negative feed-back loops from an increasingly fragile sovereign to an increasingly fragile banking system. Purely national strategies will fail to stop this banking fragility.

Third, economic growth in the euro area as a whole and in particular in the so-called periphery is very weak. Growth forecasts have been revised downwards. None of the four big eurozone economies — Germany, France, Italy, and Spain — are projected to grow more than one per cent in 2012 according to the latest forecasts of the European Commission.

During 2011, eurozone leaders have taken a number of steps to overcome these problems. At the last summit, leaders agreed on tougher and more biting fiscal rules, which are to be mostly implemented at a national level. This will help to increase fiscal discipline and thereby prevent problems of the kind currently seen in Greece happening again in the future.

Such measures will also, to some extent, be helpful in increasing investors' trust in a country's political ability to repay debt. For example, the Spanish debt break enshrined in the Spanish constitution is a strong signal and may contribute to the comparatively low interest rates of Spain as compared to Italy's rates.

In exchange for more commitments to fiscal discipline, significant money has been put on the table. This includes 200bn euros from the IMF decided at the last summit on top of 500bn of the EFSF/ESM decided earlier. Even without leveraging, up to 700bn euros could be available to help countries with liquidity problems beyond the funds committed

to Greece, Ireland and Portugal.

In addition, leaders re-affirmed their promise that Greece would remain a unique case and no other country would impose losses on investors. Private sector involvement is thus ruled out but collective action clauses (CAC) remain. The new system applying to newly-issued debt will thus be rules-based with the potential to restructure debt according to defined collective action clauses.

Markets have, however, remained unim-pressed. Italian interest rate spreads are again at around 500 basis points compared to German.

So what is missing and why is the current solution unsatisfactory?

In my view, the eurozone needs to significantly step up its efforts to fight the crisis. This ultimately will require the creation of a true eurozone finance ministry with tax-raising powers. Such a true supranational authority can provide more guidance and support in generating growth, it can supervise and insure banks and it can provide different forms of assistance to member states. Last but not least, the eurozone finance minister will need to end the current cacophony of voices.

What exactly should the new finance ministry do and how should it be structured?

First, the new finance ministry should develop a eurozone growth strategy, which is currently missing but urgently needed. Without significantly higher economic growth in southern Europe, debt dynamics in combination with price adjustment needs will jeopardise sustainability.

At the regional and national level, reforms need to focus on improving supply-side conditions for business, including better administration, governance and rule of law as well as significantly better education and innovation systems. A eurozone ministry can help foster such changes.

At a eurozone level, the current macro-economic policy mix appears excessively restrictive. Monetary policy alone will prove insufficient to boost demand. Therefore, a eurozone-level tool to boost demand is needed. A eurozone finance ministry with its own tax-raising powers could provide such a tool.

After all, it should be remembered that federal states such as the USA have strong anti-cyclical fiscal policy at the federal level while at a state level, balanced budget rules render public budgets pro-cyclical. In the eurozone the new fiscal rules, if successful, will reduce anti-cyclical fiscal policy action, which is currently anyway limited due to market pressure.

Second, the integrated euro area banking system needs an integrated and powerful banking supervision and resolution authority backed by enough means to prevent bank runs. The current system centered on national supervisors and national fiscal resources is clearly fragile.

A eurozone finance ministry should set up a true euro area deposit insurance corporation (EDIC) that would ultimately be backed by the eurozone taxpayer. This EDIC would have the power to supervise, control and if necessary resolve all systemically relevant banks in the eurozone. It would also need to correct the currently highly pro-cyclical bias induced by the deleveraging strategy announced at the last summit.

Third, the eurozone finance ministry should develop solutions to deal with debt overhang. Ultimately, if debt levels are too large to be repaid from purely national resources, financial assistance is needed. A eurozone finance ministry would have enough resources to deal with such debt crises credibly.

It may become necessary to pool all eurozone public debt in a common debt. Such a form of financial assistance would

probably be sufficient as it would lower borrowing costs enough to restore debt sustainability. To issue such common debt, a common treasury with tax-raising power appears necessary.

Currently, the interest cost of all eurozone debt is 3.7 per cent of eurozone GDP. The eurozone finance ministry would thus need tax-raising power of at least four per cent of eurozone GDP to credibly overtake all debt. National level taxes could be reduced by a similar amount so that the overall tax burden for the average euro-area citizen would not change.

Until such a political union with a clear executive exists, more summits are to be expected. The summits will need to clarify the functions to be exercised by the common ministries. They will also need to define clear democratic legitimacy of the new institutions.

A common finance ministry with tax- raising authority will need to be subjected to parliamentary control. It could be imagined that it would derive its authority from a combination of two chambers based on the European Parliament and the Council. It appears that the last summit is but one step on a long road.

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