

Constitutional
Economics
Network

Working Paper
Series
ISSN No. 2193-7214

CEN Paper
No. 02-2015

*Could Exit Rules be Self-enforcing in the EU?
The Cases of France and Germany*

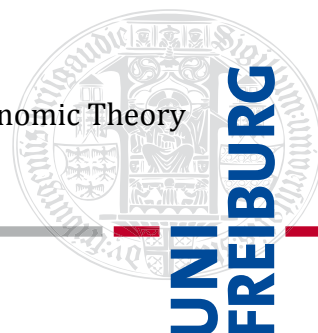
Robert Kappius* and Bernhard Neumärker**

* Department of Economic Policy and Constitutional Economic Theory,
University of Freiburg, Germany.

** Department of Economic Policy and Constitutional Economic Theory,
University of Freiburg, Germany.
E-Mail: bernhard.neumaerker@vwl.uni-freiburg.de

June 20, 2015

University of Freiburg
Institute for Economic Research
Department of Economic Policy and Constitutional Economic Theory
Platz der Alten Synagoge / KG II D-79085 Freiburg
www.wipo.uni-freiburg.de



Could Exit Rules be Self-enforcing in the EU? The Cases of France and Germany

Robert Kappius and Bernhard Neumärker (University of Freiburg)

I. Introduction

Exit rules allow for a temporary or permanent withdrawal from international cooperative regimes. For the ongoing crisis in the European Monetary Union (EMU), such rules are seen as a desirable solution to enhance flexibility in case of economic and political shocks in member countries and to restrict fiscal externalities in the Euro zone. As the EU acts as a union of sovereign countries, politically powerful nations like France or Germany are likely to blockade or circumvent such a rule, if it negatively affects their interest. The underlying strategic problem of self-enforceability is largely neglected with respect to an EU exit rule. This contribution to the political economy of exit and escape rules aims at assessing conditions of voluntary adherence to an exit scheme by all parties of a common currency union such as the EMU.

In the wake of the ongoing EU crisis, a range of authors have proclaimed the need for codified exit rules for destabilized countries (e.g. Delors 2011, Huck/Valasek 2013, Hefeker/Neugart 2015). As an important reason, an exit rule may enhance the flexibility of an international regime to cope with economic and political shocks in individual member countries. For example, the GATT and WTO architecture allows its member countries to withdraw from specific tariff arrangements to leave room for domestic policy concerns (see Bagwell/Staiger 2005). With respect to the EU and the EMU, flexibility towards domestic issues such as financial failure looms large: Structural reforms can often be implemented only in a long term, while a departure from the euro will result in a freely adjusting exchange rate that could possibly ease economic symptoms in the short run and alleviate structural reforms. A codified exit rule as part of the EMU regulatory framework may help to overcome costly speculation about Euro zone exits that leads to a continued flow of capital away from suspected countries. The uncertainty also affects financial movements and economic planning in the destabilized country in a negative way (Huck/Valasek 2013). Also, an exit rule may limit a destabilized countries' so called brinkmanship behavior, that is its potential to abuse the unions' bailout-efforts (Fahrholz & Wójcik 2013). Through this channel, market discipline is strengthened once more. By strengthening the economic discipline of relevant actors, an exit rule could even make the actual case of an actual exit less likely than in the status quo (Haider 2014).

The political economy of implementing an exit rule in the EU is largely neglected in the literature. Proponents of an exit clause commonly appeal to an impartial economic reasoning that weighs global costs and benefits of an exit (see, e.g., Blankart/Bretschneider 2012). Also, troubled countries are treated as responsible for their fate and for exploiting bail-out interests of other union members, thus insinuating a just cause for an imposed exit rule (Haidar 2014). Contrary to policy recommendations towards the "common European good" (Haidar 2014: 2), actual reforms of fundamental EU regulation are oftentimes accompanied by resistance and ongoing conflicts. Specifically for the case of financial and fiscal policy, vital *de jure* rules were *de facto* barely enacted. The obligation of financial austerity decided upon in the Maastricht treaty was rarely pursued. Reversely, the so called "non-bailout"-clause (125 AEUV) did not prevent measures such as the ESM and OMT which arguably serve as concrete bailout policies (Sinn 2012). In still other cases, economically sound changes did not yet pass the reform process (see, e.g., Roland 2000). It is therefore by no means clear, that an economically sound reform option will pass the EU legislative process and will be effectively applied afterwards. With respect to an exit rule, strategic interests of member states may be possibly opposed. For example, formerly synchronized federal debt paths of France and Germany went in opposite direction in recent years – while Germany stabilized its debt, France significantly increased borrowing, thus failing to meet the demands from the European Fiscal Compact (EFC) that was enacted only in 2012. Also, the increase of nominal unit labor costs in France as diametrically opposed to Germany (Heise 2013) hints to a different economic and political path. These opposed economic developments may well turn into opposed interests towards the design and application of an exit rule. As both France and Germany are key veto players in the EU, their corresponding interests will have to be met for a formal exit rule to work effectively.

In order to highlight the strategic interests of quasi sovereign EU member states while challenging the effectiveness of *de jure* EU law, we propose to employ the theory on self-enforcing contracts to assess the feasibility of an EU exit rule. A self-enforcing contract requires that for all relevant contingencies, all contracting partners should have an incentive to act according to the contract at any time instead of reaping the short-run benefits from breach (Klein 1985: 595). The theory strand has numerous applications in international regimes, as no supranational agency may ensure compliance to a contract. Surely this approach implies a quite extreme view towards the foundations of the European community. It should be valued as a methodological counterweight against economists' "objectivism" in EU matters: An exit

rule, if recommendable from an economic point of view, needs to reflect the current interest of all (powerful) member states in order to be both effective and viable.

Following this introduction, the next section introduces to the standard logic of self-enforcing agreements in international contexts and argues for a specific difficulty in the European case. Section 3 presents a simple model to explain the interaction environment in the EU with respect to a country exiting the Euro zone. A discussion of policy implications follows in section 4.

II. Exit Rules in Self-Enforcing International Agreements

According to the theory of self-enforcement, contracts prevail in international regimes, if they lead to Pareto-improvements compared to an otherwise anarchic equilibrium (Bagwell/Staiger 1990, Rodrik 2007: 205). As a consequence, sovereign nations obey to international law and contracts even if this implies costly behavior – as long as the overall consequences of remaining in the contractual regime are beneficial. Such a regime commonly draws its benefit from solving an externality problem: In uncoordinated international interaction, self-interested national tax or regulation policy may excessively damage other countries. A contractual regime like the GATT and WTO effectively keeps single countries in the coordinated, mutually beneficial equilibrium. The idea of an exit clause serves to improve such a regime: An exit rule may enhance the flexibility of an international regime to cope with external economic and political shocks. For example, the GATT and WTO architecture allows its member countries to withdraw from specific tariff arrangements to leave room for domestic policy concerns (see Staiger 1995, Bagwell/Staiger 2005). By paying a specific cost to other members, the country may still remain in and profit from the overall regime. This encourages more countries to enter the beneficial regime, while remaining flexible towards unanticipated contingencies and heterogeneity (Piketty 1996, Rodrik 2007).

Applied to the EU and the EMU, could an exit rule also be part of a superior union contract? An exit rule in this respect implies that member states as players must have an incentive to exit voluntarily when their economy is sufficiently harming to the union. Unfortunately, the results from the international regimes cannot be directly applied to the European case. As a reason and unlike the international regimes above, the EMU was not established to overcome a negative externality in pre-Euro Europe, but to reap the benefits from a common currency zone. Rather, the EMU even gave birth to new externalities: Among other channels, the consequences of members' fiscal discipline are striking. Therefore, national decisions whether or

not to remain in the EMU in case of a country-specific economic or political shock are assessed in the following section.

III. Modeling the Exit Decision

In order to delineate a self-enforcing exit rule, conditions must be defined under which a country that is hit by a fiscal, economic or political shock will want to leave the union in its own interest. While the ex ante conditions for a country to join a currency union may be enforced by existing members, the reason why a country would or should leave the union are generally not known ex ante. In this respect, the question is not whether the EMU Euro zone still is an optimal currency area (see, e.g., Petreski 2007, Tavlas 2009), but whether from the perspective of a specific country remaining in the Euro zone for at least another period is seen more beneficial than an immediate exit or not. We assess negative or positive economic shocks that result in a fiscal policy reaction, leading to either an expansion or a contraction of public debt. Compared to adjustments in wages, prices or even factor movements, fiscal compensation measures have proven to be quick and hard-to-resist compensatory measures in many EU instances.

A decision for or against exiting the EMU is a multifaceted assignment. Due to the highly complex decision environment, a precise model that calculates quantifiable payoffs is neither conceivable nor attractive. In order to find the elementary attributes of a self-enforcing exit rule, the basic qualitative components of such a political decision should suffice. In this respect, political motives, the benefit of the EMU, externalities as well as (optional) transfer payments are regarded as key elements of such a decision.

We assume, therefore, that in each period, countries face an economic and political sentiment $a_i \begin{matrix} < \\ > \end{matrix} a_i^*$, where a_i^* stands for the EMU average condition. The choice of a fiscal debt $f_i \geq 0$ is set according to a function of the domestic political interaction $p_i(f_i, a_i) = \min_{f_i} |a_i - f_i|$. In effect, the country will choose an f_i^* , defined as the average public debt in the EMU, whenever it faces a_i^* , otherwise an f_i close to a_i . (see, for that, also Suzuki 2012). Other conceptions $p_i(f_i, a_i)$ could be used to map different domestic politics interactions or preferences. The general form of the function that explains choice of fiscal debt is in accordance with similar international models that allow for a whole array of perceivable domestic policy objectives (see, e.g., Bagwell/Staiger 2002).

The benefits of a monetary union, G_i , largely consist in lower transaction costs and omission of exchange rate risks (see De Grauwe 2012). From a transaction cost perspective, a common currency also serves as a common standard (Blankart/Knieps 1993). All of this may

add to market transparency, direct investments and trade volume. Also, gains pertain from the Euro as a reserve currency for foreign countries. These benefits are not to be confused with the advantages of free interior market that affect the EU as a whole. Whether a currency regime may be viable in the long run crucially depends on a sufficient degree of economic symmetry and flexibility (Mundell 1961). Symmetrical economic development inhibits asymmetric shocks whereas flexible channels such as high factor mobility and flexible wage policy may function as shock absorbers. Departing from EMU benefit evaluations in the line of the Optimal Currency Area (OCA) theory (see e.g. Petreski 2007, Meier 2010), we capture consequences of asymmetric shocks not in G_i as these shocks lead to asymmetric costs, captured as externalities later on. For our purpose, qualitative gains from the common currency are captured in the term $G_i > 0$.

This does not imply, that a common currency regime is always an ex ante optimal choice for a candidate. Importantly, the loss of an independent central bank may lead even to an amplification of negative or positive shocks (see De Grauwe 2012: 9-10). In a cross border currency regime, rising distrust due to a negative shock may induce investors to withdraw money from that country and to invest it - without devaluation - in a neighboring country, leading to a further increase of the domestic interest rate. In a stand-alone currency regime, investors would be inhibited from unsubstantiated capital flight due to devaluation. However, this reasoning does not play a role if a country is already part of a currency area, because debt obligations are contracted in the common currency.

Within the EMU, externalities of domestic policies may significantly influence an exit decision. In our case, the fiscal debt ratio of one country can have an effect on other countries and vice versa. A lot has been communicated about the negative external effects of an overarching fiscal debt in one country with respect to other union members. During the first EMU decade, interest rate spreads for public bonds across the EMU were insignificantly low and allowed for excessive spending and investments in periphery states. Whether to blame local governments and investors for shortsighted decisions or uninformed and overly powerful markets for greedy speculation, does not wipe out the result of an infectious 'Angst' that spread around Europe's banking and financial system and required encompassing counter measures other than 'haircuts' for insolvent members (Heise 2013: chp. 3). For example, France feared cumulative panic and a cascade effect (Heise 2013: 20). Lack of insolvency regulations exacerbated the speculation externality of financial markets. The ECB jumped in to stabilize the Euro when southern European countries faced solvency problems. The European Stability Mechanism (ESM) as well as TARGET balances are seen as ongoing costly

bailout measures (Sinn 2012). While these measures were in part justified to make up for Greek sufferance from a self-fulfilling prophecy, it nevertheless introduced a moral hazard situation. Costs of general uncertainty and of contagion (see Huck/Valasek 2013) add to the negative externalities of excessive deficits. The magnitude of these externalities crucially depends on EMU institutional settings as well as functioning of capital markets. Among others, efforts of ECB and Financial Stability Board (FSB) to prevent systemic risks may dampen risk of contagious fiscal debts. Also, the financing of destabilized countries through ESM is contingent on reform measures that limit long term debt accumulation and moral hazard behavior. Likewise, the fiscal debt shock may entail a negative externality for other countries like Germany when in spite of its fiscal austerity it has to partake in the EMU burden. On the other hand - and less echoed in the current debate on the burden sharing in the crisis - capital flight from destabilized countries like Greece may lead to falling interest rates in trusted member states. Incidents of negative interest rates for German federal bonds in 2014 can be attributed to the crisis. Net externalities, being a potentially key factor in the decision whether or not to exit the EMU, are in principle endogenous to the EMU institutional arena. Generally speaking, the net externality $E_i(f_i, f_{-i})$ can be > 0 , indicating a positive externality for country i when remaining in the union (likely in case of excessive spending), and < 0 in case of a negative net externality (in case of austerity below EMU average debt).

Finally, there are payoffs X_i that appear when country i decides to leave the EMU. On a first account, a destabilized country ($f_i > f_i^*$) will face conversion costs, a currency depreciation and capital flight (Blankart/Bretschneider 2012). Especially the magnitude of capital flight crucially depends on the design of exit (Huck/Valasek 2013). A codified exit rule can make an actual exit cheaper, as it leads to less speculation about the exit process. For a full account, economic responses to price changes and fiscal restructuring due to higher interest rates have to be included. Therefore, an instantaneous devaluation will most likely induce the typical u-shaped economic development during structural reforms. X_i is assumed to be < 0 as immediate costs of an exit are obvious, while the gain of a stand-alone-reform compared to a guided reform process within the EMU is not evident (see, e.g., Kasimati/Veraros 2013). An intrinsic value of nationalism and autonomy (see Meyer 2010: 59) is ruled out. Those benefits of an exit that are typically evident like reduced Target2 and reform payments in the Greek case (Blankart/Bretschneider 2012: 3) accrue to other member states. From the perspective of the destabilized country they are reversely part of the externality received when remaining in the union (thus making exit more unlikely). For an outperforming economy ($f_i < f_i^*$) the opposite holds.

If a country faces an economic or political shock ($a_i \neq a_i^*$), it is able to act upon comparing the expected payoff from remaining in the Euro zone, W_i^{EURO} , and the payoff from exiting the Euro zone, W_i^{ALONE} :

$$W_i^{\text{EURO}} = G_i - P_i^{\text{EURO}} + E_i \quad (1)$$

$$W_i^{\text{ALONE}} = G_i - P_i^{\text{ALONE}} \quad (2)$$

Assuming that countries can enforce their preferred fiscal debt policy $f_i = a_i$ in any case (and ignoring the possibility of fiscal expenditures f_i higher than politically optimal due to externalities), $P_i^{\text{EURO}} = P_i^{\text{ALONE}}$, the decision reduces to

$$W_i^{\text{EURO}} = G_i + E_i \quad (3)$$

$$W_i^{\text{ALONE}} = X_i \quad (4)$$

Thus a voluntary exit will happen when

$$X_i > E_i + G_i. \quad (5)$$

This basic argument tells us that in case of a country profiting from externalities on a EMU level, we can never expect it to leave voluntarily, because $X_i < 0$ and $G_i, E_i > 0$. A transfer $T_i > 0$ has to make up for this inequality so that

$$T_i \geq X_i + E_i + G_i. \quad (6)$$

The transfer thus has to cover the costs of exiting plus the opportunity costs of not being in the union anymore. Other countries will support a collectively financed payment T_i to country i if

$$-T_i + (G_{-i}^{\text{EXIT}} - G_{-i}) \geq E_{-i} \quad (7)$$

That is, subsidizing exit and facing a less encompassing union is cheaper than suffering from negative externalities of country i as a union-member.

Facing the constraint that a breakup of the EMU is not cheaper (assuming identical EMU-members):

$$W_{-i}^{\text{EURO}} = G_{-i} + E_{-i} + X_i + G_i + E_i \quad (8)$$

$$W_{-i}^{\text{iEXIT}} = -X_{-i} \quad (9)$$

A voluntary exit will thus occur, if

$$-X_{-i} - G_{-i} - E_{-i} \leq X_i + E_i + G_i \leq -E_{-i} + (G_{-i}^{\text{iEXIT}} - G_{-i}), \quad (10)$$

stating that the effective exit costs for country i must entail less (opportunity) costs than a full union breakup (left hand side), while the remaining union is better off after the exit (right hand side).

High a_i -shock and the "downward" exit (France)

With its newly augmented fiscal debt and its power to effectively veto amendments in the EMU regulatory framework, France serves as a good example for a deficient country in this analysis. However, also small destabilized countries like Greece may arguably avert the enactment of exit rules, if the current treatise is conceived as unalterable against a members will.

An increased a_i will induce an immediate political reaction $f_i > f_i^*$, thus leading to a positive E_i for France and negative E_{-i} . According to (5), only conditional payments will make a voluntary exit plausible, as this would entail sacrificing previous bailout-payments along with exit costs. On the side of other member states, only a sufficiently severe externality E_{-i} can incentivize this costly support. As a result, current regulatory changes that limit contagion and moral hazard behavior will make a "downward" exit less likely. Alternatively, a full EMU breakup with its associated costs (exit costs, loss of union benefits but also lack of externalities) can even be a cheaper solution.

Low a_i -shock and an "upward" exit (Germany)

Due to a positive a_i , higher tax revenues and lower interest rates will ensure a lower fiscal debt that leads to negative E_i for Germany and positive E_{-i} . According to (5), a unilateral decision to exit the union is possible. Apart from $E_i < 0$, $X_i > 0$ is plausible because an "upward" exit could lead to an inverse market reaction. As there are no incentives on behalf of other member countries to subsidize this exit, it remains a self-contained action that entirely depends on the German $G_i < X_i - E_i$. Furthermore, there is no incentive for a currency union to regulate this "upward" exit: A codified exit rule that reduces uncertainty and thus improves the payoff X_i and make an exit more likely, thus destabilizes the union from the beginning.

IV Discussion and Implications

The exit rule is not a cure-all for the EU crisis. With its jurisprudential justifications and economic consequences being disputed, it also faces serious headwind from a politico-economic view as the present examination suggests. While there seems to be no point in regulating an "upward" exit from the union perspective, a mutually agreeable "downward" exit hinges not only on complex issues as the current externalities and hard-to-estimate exit costs but also transfer payments that can be interpreted as exit-contingent bailout payments. Quantifiable conditions as part of a codified exit rule may not enhance market transparency or reduce market uncertainty. Refraining from these specifications on the other hand and merely specifying unified macroeconomic conditions for an automatic exit will result in political resistance.

In line with ineffective Maastricht criteria and no-bailout clauses, even a de jure regulation of EMU exits is will then become incredible and cannot calm financial markets anymore. What the discussion on EMU exit really needs is a further specification and quantification of self-enforcing exit rules or, otherwise, powerful European institutions or a Hegemon inside the group of member-states who is forcing other member nations towards upward exits. The second option would move away from the idea of a voluntary cooperation of European nations codified by unanimous decision-making and would enact - implicitly or explicitly - a new hierarchical system in the EMU.

We prefer the first option which is clearly more in the spirit of the peaceful and voluntary architecture of Europe, and it makes more centralization of political power superfluous. But then, it is a crucial requirement to constraint and reform the common European fiscal rules towards a self-enforcing European fiscal constitution. The mix of the Maastricht criteria and the no-bailout clauses is not self-enforcing at all. Some new mix may survive the enforcement test when the suggested exit rule is added. If Europe does not start the engine to be

in search for truly self-enforcing (exit) rules one has to fear that not perfectly controlled evolutionary processes will drive the decision making of the EU and EMU in the direction of involuntary, hegemonic and conflictuous solutions.

References

- Bagwell, K./Staiger, R.W.: A Theory of Managed Trade. *American Economic Review* 1990 80, pp. 779-795.
- Bagwell, K./Staiger, R.W.: *The Economics of the World Trading System*. Cambridge, Mass. et al: MIT Press 2002.
- Bagwell, K./Staiger, R.W.: Enforcement, Private Policy Pressure, and the General Agreement on Tariffs and Trade / World Trade Organization Escape Clause. *Journal of Legal Studies* 2005 34, pp. 471- 513.
- Blankart, C.B./Bretschneider, S.: Nutzen und Kosten eines Austritts Griechenlands aus dem Euro, ifo Schnelldienst 9/2012, pp. 3-7.
- Blankart, C.B./Knieps, G: State and Standards, *Public Choice* 1993 77, pp. 39-52.
- De Grauwe, P.: *Economics of Monetary Union*, 9th Ed., Oxford: Oxford Univ. Press 2012.
- Delors, J.: Delors Urges Giving EU Power to Eject Nations from Euro. Reuters (Paris) 18 October 2011. <<http://www.reuters.com/article/2011/10/18/eurozone-delors-idUSL5E7LI2KF20111018>> (last accessed 25.03.2015).
- Fahrholz, C./Wójcik, C.: The Eurozone Needs Exit Rules. *Journal of Banking & Finance* 2013 37, pp. 4665-4674.
- Hefeker, C./Neuhaus, M.: Fiscal Transfers in a Monetary Union with Exit Option, CESifo Working Paper No. 5244. Munich 2015.
- Heise, M.: *Emerging from the Euro Debt Crisis - Making the Single Currency Work*. Springer Heidelberg et al. 2013.
- Huck, S./Valasek, J.M.: Institutionalizing Eurozone Exit: A Modified NEWNEY approach. CESifo Working Paper No. 4116. Munich 2013.
- Kasimati, E./Veraros, N.: Should Greece Adopt a Dual-Currency Regime to Resolve Its Economic Crisis? *Journal of Policy Modeling* 2013 35, pp. 588-600.
- Klein, B.: Self-Enforcing Contracts. *Journal of Institutional and Theoretical Economics* 1985 141, pp. 594-600.
- Meyer, D.: Währungsdesintegration in der EURO-Zone: Staatsbankrott und Inflation als zwei Szenarien infolge der Finanzmarktkrise. *Jahrbuch für Regionalwissenschaft* 2010 30, pp. 45-70.
- Mundell, R.: A Theory of Optimum Currency Areas. *American Economic Review* 1961 51, pp. 657-665.
- Petreski, M.: Is the Euro Zone an Optimal Currency Area? Working Paper. School of Business Economics and Management, University American College Skopje, 2007. Available at <http://ssrn.com/abstract=986483>.
- Piketty, Thomas: A Federal Voting Mechanism to Solve the Fiscal-Externality Problem. *European Economic Review* 1996 40, pp. 3-17.

- Rodrik, D. *One Economics, Many Receipts: Globalization, Institutions, and Economic Growth*. Princeton-Oxford: Princeton Univ. Press 2007.
- Roland, G.: *Transition and Economics: Politics, Firms, Markets*, Cambridge: MIT Press 2000.
- Sinn, H.-W.: TARGET losses in case of a euro breakup. VoxEu, October 22, 2012.
- Staiger, R.W.: International Rules and Institutions for Trade Policy. In: G.M. Grossman, G.M./Rogoff, K., eds., *Handbook of International Economics*. Amsterdam: Elsevier 1995, pp. 1495-1551.
- Suzuki, Y.: *Centralization, Decentralization and Incentive Problems in Eurozone Financial Governance: A Contract Theory Analysis*. Working Paper, Hosei University 2012. <<http://repo.lib.hosei.ac.jp/bitstream/10114/7978/1/170suzuki.pdf>> (last accessed 21.05.2015).
- Tavlas, G. S.: Optimum-Currency-Area Paradoxes. *Review of International Economics* 2009 17, pp. 536–551.