The Price of Uncertainty: the European Economy and Speculation

Jean-François JAMET

Since the beginning of the financial crisis, the European economy has faced uncertainty which has fed into the recession, causing panic in the financial markets and worsening the debt crises in several Member States. Moreover, it continues to impede recovery by preventing investors from correctly gauging the risks they are taking. This uncertainty firstly affected the banks and then the States. Uncertainty, like the crisis, has become systemic. In such a context, economic players legitimately turn towards decision makers to get some visibility and mid-term guarantees.

The responsibility of political players is therefore colossal. However, the institutions of the European Union and the euro area have not played their role to the fullest from this point of view. Existing rules, especially those of the Stability and Growth Pact, have lost their credibility because they have not been respected by the Member States and because they were incomplete, ignoring current account imbalances and private debt. The Commission has failed to coordinate effectively both recovery and austerity plans. The Council has delayed in setting up an assistance mechanism for the States that were in danger of collapse and is also slow in agreeing on the creation of a mechanism for the management of sovereign default. The ECB as not been explicit with regard to the future of its quantitative easing policy and about the purchase of bonds of those governments that are struggling on the secondary market; it indeed admits to being divided over which policy it should adopt.

European political decision makers have gradually become aware of the cost of uncertainty which feeds speculation and brutally cuts short economic players' perceptions. They launched plans to rescue banks and then States; they were pragmatic with regard to institutional constraints to increase their ability to act whilst preparing new, more credible supervisory rules for the future. Rebuilding a more predictable environment has however become a sizeable challenge in a time of high volatility and repeated crises. What are the conditions for recreating a predictable economic environment in the EU?

From the danger of debt to the crisis of uncertainty

Keynes gave an enlightening definition of uncertainty, distinguishing it from the idea of risk: uncertainty is a situation in which "there is no scientific basis on which to form any calculable probability whatever"[1]. This definition seems to be particularly relevant in the present context. From the mid-1990s on, the developed economies in the Western world lived under the illusion that the "Great Moderation"[2], a period of decline in macro-economic volatility would be sustainable. This stability even gave sufficient confidence to economic players for them to accept growing debt: confident in the stability of growth and inflation for the years to come, they did not hesitate to borrow or lend since reimbursement seemed to be subject to a controlled, predictable risk.

This apparently calculable period of risk suddenly came to an end with the crisis it triggered. The complexity of financial deals, revelations about levels of debt and the inter-dependence of economic players, both debtors and creditors, plunged the economy into doubt: first the banks refused to make mutual loans thereby paralysing the inter-bank lending market, then they restricted lending to the economy. The States which were asked to recapitalise the banks and take their place to jump-start growth have witnessed a significant rise in their deficits, a phenomenon that was accentuated by the recession. This was when solidarity between Member States was put to the test.

Aid to the States that face a sovereign debt crisis is vital but it faces several hurdles. The first lies in the financial fragility of the States that provide the funds, because it creates a risk of contagion and limits the possibilities of mutual aid. The second lies in the level of solidarity which the euro area member countries and public opinion are prepared to show: the Greek crisis revealed the reticence of certain public opinions with regard to helping States that had not been very exemplary in terms of their macro-economic management[3]. The third difficulty lies in the legal insecurity associated to these aid plans. It is not clear that these measures are compatible with the Treaties (because of the non-bail out clause) and it is possible for them to be challenged, including before the national courts, as was pointed out by the German Constitutional Court. A fourth difficulty lies in the acceptability of budgetary stabilisation and structural adjustment measures on the part of the populations concerned. The Irish crisis illustrated the humiliation felt by a country receiving conditional aid and the type of political crisis that can be triggered as a consequence. Finally, the fifth difficulty is associated with the very possibility of stabilising the public accounts of States experiencing problems. Austerity measures can only succeed if they do not aggravate the recession in the countries in question. Doubt over the resilience of these economies is leading to a continued risk of default and is discouraging investors. The implementation of aid plans in Greece and even in Ireland was necessary but it will not be enough.

---

1. J.-M. Keynes, "The General Theory of Employment" *The Quarterly Journal of Economics*, February 1937.
2. See «The Great Moderation», a speech given by Ben Bernanke, who has since become the Chairman of the Fed, during the meetings of the Eastern Economic Association in Washington DC, 20th February 2004.
3. See J.-F. Jamet, "German Ethic and European Spirit: Can Germany guarantee the euro's stability?", *European Issues* - Policy Papers of the Robert Schuman Foundation, n° 182, 2010.

What has to be done to recreate predictability and reduce uncertainty?

There are not many instruments available, and waiting for better days is not a solution: the cost would be too high. Some clarifications are essential:

The rapid adoption of a legislative package by the Commission[4] in September 2010 was a vital element in recreating mid-term visibility. In particular this means guaranteeing the quality of future supervision and ensuring better quality statistical information[5]. Information is a key element to counter uncertainty. The opacity of Greek accounts, together with the tacit approval of the Council must no longer be possible. It is a matter of credibility for the euro area.

Re-establishing confidence with regard to the strength of the banks is imperative. This was the aim of the stress tests undertaken during the summer of 2010. These showed their limits however. Indeed, Irish banks such as the Allied Irish Banks passed the tests successfully, but they had to be saved from bankruptcy with emergency re-capitalisation undertaken with the support of the EU and the IMF. The stress tests therefore lost all credibility and the financial markets are again suffering uncertainty with regard to the real exposure of European banks. A new, more convincing exercise in stress tests or a recapitalisation plan for banks at risk should be put foward rapidly to show that the European Union and its Member States are not trying to cover up the reality of the banks' situation.

Making the European Financial Stability Fund permanent and clarifying its legal status in the Treaties is another priority to ensure that the measure is legally guaranteed. It would seem appropriate to ensure the rapid adoption of the corresponding modification in the Treaty so that it is applied before the present Fund's mandate expires – mid-2013 - and before the markets can speculate on its possible failure. It is true that this aid mechanism carries a moral risk, since negligent States know that they will benefit from the help of their partners. The risk is however limited due to the conditional nature of the aid, whose political price is considerable for the governments who take advantage of it. Moreover, the risk is reduced also because of the supervisory and sanction measures included in the legislative package which the Commission presented in September.

It is not very realistic to count solely on an improvement in the economic situation or on an increase in budgetary restrictions for the absorption of the debt accumulated by some countries. Two instruments could be intelligently combined together. Firstly, clarification by the ECB over the continued purchase on the secondary market of bonds of governments that are struggling would be useful so that financial players would not be left in the dark about the institution's approach on the subject. The implementation of an orderly default mechanism would then reassure the financial markets of the European Union's ability to face a possibility such as this: it is an open secret that partial default is highly likely in at least one European State and it would be better to create a mechanism to solve it beforehand, taking on board the danger of moral risk, rather than defining an emergency negotiation framework with the States' creditors. Several proposals have been put forward[6], including by the Eurogroup on 28th November 2010. *In fine*, the creation

4. European Commission "EU economic governance: the Commission delivers a comprehensive package of legislative measures" Press releases, IP/10/1199, 29th September.2010.
http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1199

5. Eurostat will notably enjoy auditing powers over national budget statistics of the Member States which find themselves in excessive deficit.

6. See for example D. Gros and T. Meyer, "Towards a Euro(pean) Monetary Fund", *CEPS Policy Briefs*, 17th May 2010; J. Pisani Ferry et alli, "A European mechanism for sovereign debt crisis resolution: a proposal", *Bruegel Blueprint*, 9th November 2010; J. Delpla, J. von Weizsäcker, "The Blue Bond Proposal", *Bruegel Policy Brief*, May 2010.

of a European Monetary Fund[7] would lead to coherence by associating a Permanent Stability Fund with an orderly default mechanism, and at the same time market discipline would be maintained.

Finally, the European Union has to win back the investors' confidence and recreate growth prospects in Europe. It must therefore have an investment strategy[8] to complete the EU2020 strategy, thereby making it concrete. This means protecting public investment from austerity measures, enhancing investment incentive instruments (by enlarging the role played by the EIB), launching community initiatives such as joint technology initiatives[9] and making better use of the cohesion funds to support investment temporarily in the countries that are experiencing the most severe recessions and which are suffering tight restrictions in terms of public finance. This should make it possible to avoid the previous failures of the IMF's adjustment programmes in which stabilisation killed off growth because it compromised investment. This strategy, together with the structural reforms that are required to redress competitiveness of certain Member States, should also lead to an inversion of the trend which had started in many European countries prior to the crisis, namely the decline of the share of investment in GDP. The issue at stake here is simply providing support to one of the vital elements of Europe's potential growth.

***

If, according to Emile de Girardin "government means anticipating"– government also means enabling economic players to anticipate. The European economy has however been plunged into uncertainty which is undermining its stability and growth. In this context it is up to European political decision makers to create the conditions for a return to a predictable environment in the European Union. European governance must be reformed in this sense:[10] only a clear, credible response will lead to the re-creation of normal operational conditions for the economy, that is a return to a situation in which risks are predictable, quantifiable and do not discourage investment.

7. D. Gros., T. Mayer,. "How to deal with sovereign default in Europe: Create the European Monetary Fund now!" *CEPS , 202.*, 2010 J.-F.Jamet, "The European IMF is Possible" *Les Echos*, 16th March 2010.

8. On this point see J-F. Jamet et G. Klossa, «A Europe that Dares», EuropaNova, May 2010.

9. Joint technology initiatives are projects that associate companies, research laboratories and universities on the basis of private and public investment (public funds from the Commission and the national governments). The areas concerned at present are global monitoring for environment and security, nanotechnologies, the reduction of pollution in air transport, hydrogen fuel cell, innovative medicines and embedded computer systems.

10. With regard to this see the article by Thierry Chopin in this book: «*Europe and the Need to Decide: Is European Political Leadership Possible?*".