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Facing the Economic and Financial Crisis: Regulation, Investment, Solidarity

The Euro, Markets and Politics

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Under pressure from the markets partial solutions are currently being found for the euro zone crisis. Recent financial turmoil, linked to the delay in setting up the EFSF and the persistence of contagion towards "heavyweights" in the zone, are emblematic of this tension between political time, subject to democratic rule, and the short time spans of the markets.

The methods for resolving the crisis behind closed doors, the ascendant position taken by the Franco-German couple within the European Council, the recurrent declarations made by the Eurogroup president regarding the need to limit Greek sovereignty, the role in managing the crisis devolved to the Troika and the nomination of technical governments in Greece and Italy, almost mandated by the European elite, are all so many signs of the increase in power of "technocratic governance". Political scientists discuss the scope of this movement: democratic deficit or not? It is not unusual for periods of high risk to lead to exceptional methods. A strong tendency or a parenthesis, public deficits on the one hand and democratic deficits on the other, place States under the double threat of brutal debt market reactions and social explosion. Both risks added together create uncertainty as to the European integration process, unequalled since 1957.

Market time and democratic bypassing is necessary, however, when States do not integrate "long run" into the decisions they make prior to crises adequately. The shortcomings in the euro zone were identified years ago - right from the outset in fact. From 2005, the board of governors had also sent an initial analysis of the multiple signals of price and cost divergence within the zone to the Eurogroup and asked the authorities to give more in-depth consideration to the problems of real convergence and particularly competitiveness[1]. We might also probably add to this inertia errors of analysis. There are many who believe that differenciation of risk premia on interest rates would be limited under the single currency. The lack of any clear mechanism of insurer of last resort in case of sovereign default and, specifically, the ban put on the ECB from directly supporting a State, now appear as congenital weaknesses of the euro which, with hindsight, have been extremely costly. It is this failing that countries in the zone are now very late in facing. This factor is, nevertheless, just one stage in a re-working process that must go much deeper, one that the politicians must initiate immediately, at the risk of putting the euro zone well and truly, and lastingly, under the tutelage of the markets.

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1. SEBC monetary policy working group (2005) "Competitiveness and the export performance of the euro area", study n° 30 in the ECB studies series.

The euro and market time

Market time compared with the time taken by diplomatic negotiations

In Brussels on 27th October 2011, a defensive mechanism was put in place intended to re-establish market confidence and avoid the spread of the crisis within the zone. The agreement proposes a review of the format of the EFSF, restructuring of the bank component within the Greek debt (to a total of €102 billion) and sets the principle of recapitalisation of the banks. The EFSF is a tool to guarantee and mutualise risks in the euro zone. It has a twofold aim of ensuring liquidity on the primary public bonds market and of participating, as a last resort, in the recapitalisation of banks. By taking action at these two levels, amongst the States and the banks, the new mechanism is supposed to minimise the probability of systemic financial crisis.

Europe has been criticised for its slowness in finding a joint solution in response to the emergency situation. Market time is not the same as time required for arbitration at inter-governmental level. This is also true for the G20, which is suffering from this excessive gap between intentions, decisions and then performance. It is nonetheless true that what has caused the problem is less the institutional slowness than the mistake made in analysis, as demonstrated by the lack of any credible mechanism to prevent crises. Continental Europe finds itself in a paradoxical situation. Although not the epicentre of the crisis that has shaken the world since 2007-2008, and particularly not having suffered from any kind of massive and generalised drifting of private debt (with some notable exceptions, including Spain), it is nonetheless seen as the weak financial link as the crisis comes to an end. This turnaround leads one to presume that there are major shortcomings. If the euro zone had been given a guarantee fund right from the very outset, in a credible format, the market would probably not have played on the differentiation of premiums within the zone. In the absence of any high *spreads,* the problems of public finance unsustainability would be much less intense, and probably restricted to Greece. The banks would also be less fragile. The prior existence of a support fund or less drastic provisions regarding the purchase of bonds by the ECB would perhaps have enabled the tool to avoid being mobilised, with risks remaining latent. Its late creation, within a context of very high interest rates in peripheral countries, forced not only the creation but also the actual use of the instrument. The markets dictate their own law only because the politicians did not use the time available to them. The markets had actually left them over a decade to do this.

Market impatience in response to lack of growth and unemployment

Strains in the markets in fact reveal less impatience in response to the time required by democracy, than with the problems caused by slowing growth and its consequences on unemployment. The markets are issuing a contradictory injunction for rapid consolidation of the financial imbalances and hyper-sensitivity to the signals of a slowdown in growth. This contradiction, which rejoins the question of short term/long term articulation, is a source of instability. Yet this instability is set to last because, even considering the fear of a repetition of “the error of 1937[2] ”, the dilemma of economic policy is difficult to manage. Of course, consolidation is compatible with a preservation, even a restart, of growth drivers in the long term by structural policies and targeted investments

2. Eggertson and Pugsley, “The mistake of 1937: a general equilibrium analysis”, *Bank of Japan Monetary and Economic Studies*, 2006. The process of budgetary consolidation begun by the federal American government and the FED’s policy to combat inflation plunged the United States into another recession.

for the future. But the response time associated with these two types of orientation are not the same. The tightening of the fiscal policy comes into play within a year, whereas the effect of structural policies is much more spread out. Yet over two points of GDP must still be contributed first [3] in the euro zone in order to bring deficits down to sustainable levels. Throughout this transition phase, it is highly likely that the markets will be subject to a high degree of volatility.

It is not so much the slowness of the democratic process that should be pointed at, as the delays of countries in giving themselves the institutions required for stability of the euro zone and a lasting single currency. The fact that the euro zone is not an optimum currency area is nothing new. Moreover, does any optimal currency region actually exist, that is to say with respect to the strict criteria posed by economic theory and particularly by Nobel Prize winner Robert Mundell? Imperfection and heterogeneity imply either the need to prevent any kind of nominal divergence or the establishment of inter-regional transfer instruments, an option that Germany does not want to use.

The euro and policies' time

Extinguishing the fire and then rebuilding: managing heterogeneity

The EFSF and the emergency solutions adopted by States within the inter-governmental framework are aimed at the immediate symptoms of the European crisis. Faced with the crisis in the euro zone, the objective since 2010 has been to contain the effects of contagion towards Italy and Spain and towards other countries which, in the "sequential" process of the markets, would come afterwards.

These mechanisms do not resolve the deepest causes of the crisis in the euro zone. Resolution of the crisis is not possible by means of a simple cocktail, mixing a measure of EFSF and a measure of tighter fiscal rules. The euro zone cannot last for much longer without truly coordinated macro-economic and structural policies and renewed governance. This is the challenge facing Van Rompuy's task force, whose work began in March 2010. This process, which received less media coverage that the emergency treatment given to the Greek crisis, resulted in the "governance package" examined by the EU Council in March 2011 and adopted after lengthy discussions at the end of September by the European Parliament. The principles set forth in this new renovated governance framework commit the euro zone to extended supervision of its "excessive" imbalances. This framework is certainly more relevant than the previous one from the point of view of the economic principles on which it is based, but it is also more complex (and still rather hazy) with regard to the indicators to be supervised. Practical implementation has yet to be invented. The proposals made in November 2011 by the Commission President, including on "stability bonds", complete the previous ones. But they raise the same questions regarding the fragile political consensus within Europe and the difficulties entailed in taking action.

The heart of the problem lies in the real divergence of economies and the absence of any automatic mechanisms for re-equilibration of intra-European current account imbalances. The crisis in the euro zone is not just a debt problem. It is also the consequence of poorly managed heterogeneity within the zone, particularly sub-competitiveness of part of Southern Europe with regard to Germany, which is top of the European class in terms of both price and non-price competiveness, and a few other countries that form the "hard core" of Europe.

3. Much more ex post within a context of growth below its potential.

The increasingly marked asymmetry of current account balances within the European area bear witness to the difficulty in reducing imbalances by playing on relative prices alone. Alongside this, inter-regional financial transfer instruments have proved to have insufficient scope in the event of any deep crisis.

The ECB pointed years ago to the dangers induced by divergence in costs and prices inside the zone. This divergence has been accompanied by increasingly marked imbalances in terms of bilateral balances of payment in Europe. Since then, much research work[4] has found an intensification of problems with competitiveness, with, as a background, a high degree of disparity in terms of productivity levels and unit costs in Europe. Adjustment through prices is necessarily slower than adjustment through exchange rates. Asymmetric shocks are alleviated not only slowly, but differences in productivity levels weigh heavily on the margins of exporters and, in the longer term, on market shares. Financial imbalances can then prove cumulative. The tightening of credit limitations in the event of financial crisis also limits the possibilities of finance for innovative sectors and contributes to the real divergence of economies. Within a context where there is no automatic correction mechanism for imbalances, the danger of seeing them grow tendentially is great. This means, in substance, that there exists, in areas in deficit, an increasing number of agents exposed to a risk in terms of solvability or liquidity. Within this context, the insurance instruments set up at any given time regularly risk proving to be of insufficient size. The EFSF has, moreover, been reformatted three times since it was established, a year and a half ago, and this could probably happen again.

The European Central Bank: lender of last resort?

Faced with the real divergences that exist, in the short term, in order to prevent any systemic risk, the EFSF (European Financial Stability Facility) must not have any previously fixed limit on its striking force. Because experience shows that as soon as this kind of limit is announced, the markets (in reality a certain number of operators and investors) want rapidly to test its strength and political credibility. Such was and remains the spirit of France's proposal, and that of a certain number of economists, to "connect" the EFSF to the ECB and thereby open up a refinancing capacity and an ability to access liquidity that is not capped to begin with. Until now this proposal has been rejected by Germany, for reasons that are both economic (risk of inflation, through the monetisation of public debts, in case of limitless refinancing of the EFSF through the ECB) and legal (risk of violation of the Maastricht Treaty with regard to the rule of "no bail-out" of Member States by the ECB and therefore banned by the Karlsruhe Constitutional Court). With its back to the wall Germany has nevertheless shown itself to be more pragmatic than it had said itself to be and than had been foreseen by others. If a real systemic problem were to arise in the zone, coming from Italy or Spain, we would have to go beyond the €1000 billion announced in the Brussels agreement of 27th October 2011 and articulate in one way or another, the EFSF and the ECB. In a scenario such as this legal arguments would probably give in to the principle of economic and political reality. The appropriate legal solution would be found only afterwards.

Reconciling rigour, growth and solidarity

How can rigour and growth be reconciled, how can we find a balance between negative opinion causing lack of mobility and more positive messages? It is important to walk "on both legs", i.e. to stay the course over time to achieve a reduction in deficits and public debts, take initiatives to increase growth that is far too moderate and improve

4. On this subject see the recent COE-Rexecode report, directed by M. Didier and G. Koléda: *Compétitivité France Allemagne : Le grand écart*, Paris, Economica, 2011, 135 p.

unemployment figures in general and youth unemployment in particular, which may rise. How can both aspects be reconciled? By financing future expenditure (R&D, innovation, education, SMB development, etc.) using more active mobilisation of the private saving available, at national and European level. A recession would certainly not be the right solution to get public finances back on track.

The definition of rules for public as well as private financial imbalances would be a good way, to avoid a break up of the zone in the long term. The European crisis suggests that it is artificial to separate public and private debt, and to reason only in terms of sovereign debts. Two examples illustrate this. In Ireland private over-indebtedness, including that of the banks, which accompanied the property bubble and led to massive intervention by the State and the sharp increase in the public debt when the property bubble exploded. In Spain the ratio of public debt (68% of GDP) is not the n°1 problem unlike in Greece or Italy. Fragility is due to private over-indebtedness and the resulting vulnerability for regional savings banks. This is the road that the Commission would appear to be taking with the establishment of a supervision and sanctions procedure for "excessive imbalances". This direction is, however, not an easy one to put into practice.[5]

From a strictly fiscal point of view, the establishment of constitutional rules would appear to be the necessary counterpart to the development of insurance, transfer and inter-regional equalization tools. They may also take the more flexible form of independent fiscal committees, as is the case of the Swedish fiscal policy council. In view of the difficulty in applying mechanical rules to the paroxysms of a crisis, the second solution may be necessary during a transitional phase.

The risk of rules failing within a context of price rigidity should also be underlined. By making the whole adjustment weigh on public finances, the danger is that these freshly created rules will lose their credibility. Because in an environment where prices are rigid, fiscal multipliers are particularly high. Increasing or persistent deficits are firstly the consequence of the real divergence of economies. It is very difficult for States to re-establish public finances when the industrial base shies away and unemployment is on the increase.

So Member States really must reduce their public deficits when growth so permits, in order to gain contra-cyclical fiscal room for manoeuvre when growth diminishes. The systems of sanctions applicable to euro zone member countries that lastingly deviate from public finance standards must also be made tougher, not now in the middle of a crisis but in the future. Depriving lastingly deviant countries of their voting rights in European bodies or of access to structural funds throughout the periods of deviation would appear to be a more efficient sanction than penalty deposits with the ECB on which the current mechanism relies. After much hesitation about what sanctions to apply, now, at the end of 2011, the debate is heading in a direction that is much better, because it is more credible.

Increasing policy coordination and mutualisation of debts

5. From what level should excessive imbalance be sanctioned? There is current debate on imbalances of payment that are sustainable within a monetary zone. A current account deficit does not always indicate economic dysfunction and may be optimal according to its macro-economic situation. Specifically, account must be taken of the structure of financing of the economy. Monetary financing does not have the same scope as financing by direct investment, which witnesses to anticipations of positive profits within a territory. The commission's analysis cannot therefore apply a mechanical rule and, in particular, a fixed threshold. The analysis must thus be circumstanced. Should there also be symmetry in the sanction of excessive imbalances? One may suppose that symmetry is the very basis for coordinated action but it would appear difficult to combine this situation with sanctions, particularly when they are addressed at Germany and its excessive surpluses.

Consolidation rather than partition of the euro zone

If Europe wants to avoid a scenario in which the consolidation targets it has set itself fail, it is essential that it also takes action on coordinated adjustment of prices. This means specifically that the ECB could, at least in the crisis resolution phase, initiate a policy known as *price targeting*, in which countries in surplus and with low inflation rates, would temporarily relax their grip on salaries and inflation whilst countries in deficit would implement wage moderation. This is not a matter of challenging the average target in the euro zone, but of lightening adjustment for countries with a competitive handicap. Undertaken separately, in Greece or in Portugal, wage deflation policies raise fearsome political and social challenges of inequality and acceptability by public opinion and citizens, and tolerance thresholds. It would also be advisable to give Greece more time in which to get back in line in terms of public deficit, in the knowledge that, in any case, a great deal of time will be required to correct the public debt ratio.

Within this context, partition of the euro zone between North and South would involve more dangers than benefits. The gap between the two groups of countries would only grow, with more efficient countries benefiting from virtuous circles and the others getting bogged down in vicious circles. The same name, euro, would then be used for different, increasingly divergent realities. Moreover, how could this type of division in the euro zone operate within the reality of a single market? With a euro zone reduced to just a few countries we would lose the advantages of size, demography, economies of scale, geopolitics, etc. It is far better to consolidate Europe than to “slice it up”.

The crisis: an opportunity for progress in the economic and political governance of the Union

To avoid recurrent crises, which would end up putting both the euro zone and the euro itself in danger, we must use this crisis as a springboard towards better economic and political governance within Europe. In practice this means giving the euro zone and the Eurogroup more of their own powers, reinforcing national fiscal policy supervision mechanisms and sanctions in the euro zone, heading for greater integration and coordination between the 17, and, if necessary, institutionalising a Europe of variable geometry which actually already exists.

Hitherto the serious crisis in the euro zone is not a crisis of the euro as a reserve currency and reference currency. Firstly, the euro exchange rate against the dollar remains high, overvalued by around 20% in a bilateral exchange rate after two years of sovereign debt crisis in the zone. This means that the world has not sold the euro massively, suggesting that, in the mind of many operators, the American dollar is fragile, weighed down by the deficits and debt of the United States and disputed in terms of its international role, at least verbally, by the Chinese and a few others. Also, the euro’s market shares, whether in terms of currency reserves held by central banks, world trade invoicing, the currency market or the international bond market, have not fallen over the past two years, quite the contrary in fact! That being said, if turbulence goes on much longer there will come a time when the euro zone crisis will pose a problem in terms of the image and credibility of the euro itself.

In the long term, pooling of sovereign debts in the euro zone is desirable. Pooling should remain partial to avoid taking responsibility away from Member States. This is a classic problem of moral hazard. It will take time, because there is no lack of legal and factual obstacles. The Karlsruhe Constitutional Court ruling, last September, implies, without actually mentioning them, that for German national sovereignty it would not accept euro bonds.

Euro bonds would have the advantage of creating in Europe a public securities bonds market, in a better position to rival the American securities market and with a depth and liquidity that would bring financial benefits with them. However, one should be aware of what the creation of euro bonds implies: much more intra-European coordination, not to say integration of fiscal and tax policies and of the public debt than is the case as things stand. This link between euro-bonds and the counterparts in terms of supervision of national fiscal policies underlies the proposals made by the European Commission in November 2011, to which we have already referred, regarding *stability bonds*. In the long term we will look towards euro bonds formulae because the crisis shows that the current functional and institutional configuration must evolve if we are to consolidate the euro zone, the euro and Europe, and avoid recurrent crises.

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A combination of vision and pragmatism is necessary in order to regain confidence and stability. As things stand, Europe is singularly lacking in vision and project, for many well known reasons. Although the crisis is encouraging more inter-governmental initiatives, the Commission must regain a proactive role instead of one that is merely reactive. Pragmatism is also necessary. It has inspired some of the developments seen over the past two years. That means, for example, reinforcing the powers and prerogatives of the euro zone alone, adapting the EFSF to the needs of the hour and implementing the national fiscal policy coordination that must go alongside the single currency viability. The ECB has shown proof of a good measure of pragmatism since the start of the world crisis and the breakout of the crisis in the euro zone. It can do more, without seeking to reply specifically to activism on the part of the Fed. But the ECB cannot be asked to make up for shortcomings in the coordination or integration of other fields of economic policy or for the hesitations and misunderstandings between member countries and their political leaders. European citizens are legitimately preoccupied by the slowdown in growth and the persistence of unemployment. Since 2008, Europe has adapted to exceptional circumstances, innovating without altering the founding treaties (examples of responses to the banking crisis after Lehman Brothers went bankrupt or the ripostes in answer to the crisis in the euro zone since 2010). Of course, the Lisbon treaty has shown its limitations and insufficiencies, if only due to maintenance of the rule on unanimity between the 27 on subjects that affect above all the 17 in the euro zone. But does that mean that now is the time to open up a constitutional debate, resulting in major "grooming" of the founding texts? In view of the urgency of the economic and social challenges to be met and the current image of Europe within the minds of Europeans, one would doubt it. But we can certainly not wait for prior modifications to treaties before dealing with the current crisis and responding to demands in the short term. In the present crisis phase all the necessary answers must be brought, even without texts, in order to show those promising the worst that they are wrong. There will still be time later to reconcile law with fact.