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The Euro area in autumn 2010: Economic policies on a razor edge?

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SUMMARY In the autumn of 2010 the 27 EU States succeeded in achieving growth once more – admittedly this was hesitant and weak - after mastering an uncommonly severe period of financial and monetary turbulence. At the same time all of the governments opted for economic policies that focused on a substantial, rapid reduction in deficits that had increased sharply due to the crisis. National situations contrast sharply. Germany is recording high economic and financial performance rates whilst its neighbours face slow growth and major debt. But most importantly the crisis showed that Europe was able – even after laborious efforts – to put together credible joint, community-based responses. The Euro Area will only find a long lasting solution to deficit crises and the need to build a sustainable, vigorous growth strategy if it resolutely moves towards establishing a truly European framework to pilot national budgetary policies. The States' different approaches should not be a discouragement to taking on this rather difficult task that will only succeed thanks to a progressive, on-going process. Everything will depend on the ability of the "big" States, whose role is so important for the entire European structure, to agree on a joint budgetary doctrine. As the Deauville summit on 18th October has just illustrated France and Germany's ability to define a joint doctrine is the vital condition required to take Europe towards a budgetary strategy.

INTRODUCTION After the tension in the Euro Area in the first half of 2010 the 27 EU Member States seem to have succeeded in emerging from the storm caused by market concerns over some southern States (Greece, Spain and Portugal). Growth is gradually gathering strength. At the same time most States including those exterior to the Euro Area such as the UK, have announced unprecedented policies to reduce public deficits.

In a way the Euro Area countries, although they have fragile, contrasted situations continue to apply economic policies that are deemed credible unequally by the markets, they also face the need to follow a narrow path set between financial stabilisation and the imperative not to affect the progressive strengthening of growth rates and yet find themselves in an post crisis situation that is not as serious as the USA or the UK whose deficits and public debt levels are far beyond those of countries in the Monetary Union (EMU).

The creation last May of a Stabilisation Fund dissipated financial uncertainty over the possible bankruptcy of the weakest States and can be considered as the first successful stage in the building of financial solidarity between States. This process has to continue moving forwards with the development of community supervisory procedures for budgetary policies. Of course this implies a laborious process; since the States, notably the biggest, are still very particular about what they consider to be one of the main attributes of their sovereignty. But we can count on the ability of the Franco-German couple to bring a common vision forward – as it did during the spring financial storm – although initially they have started from quite different positions, the couple intends to use these in the construction of a community budgetary strategy.

In the end it is predominantly the image of Europe running on a razor edge that we see in the autumn of 2010. Slow growth experienced by most European economies is the cause of major dilemma in setting up a credible path to emerge from the crisis. The compromises and innovations that may result could open up the means to long term solutions. Working towards budgetary convergence must still be the main priority in the months to come.

1. WEAK, CONTRASTED EUROPEAN GROWTH IS CAUSING THE STATES A PAINFUL DILEMMA SHORT-TERM.

The movement towards recovery is now undeniably underway in Europe, notably because of a new rise in strong international activity (+4% in 2010-2011). Growth is high in the emerging countries which retrospectively appear only to have suffered a sharp jolt in terms of growth (+6.1% in 2008 and +2.5% in 2009) whilst the West suffered a recession that had not been witnessed since the 1930's. Activity seems to be moving at a lively pace for the emerging and developing countries with activity progress rates in 2010 of 9% in Brazil, 8.6% in India and 11.9% in the first quarter in terms of annual growth for China where there is a risk over overheating.

In the USA recovery is still chaotic notably due to the stalemate on the property market. In the face of an extremely delicate financial situation (deficit of -10.7% of the GDP and a public debt of 93% of the GDP), the American Administration has extremely limited room to manoeuvre and unemployment (9.7%) is stalling the recovery of consumption. Given these conditions the most recent forecasts published by the IMF [1] mean weaker recovery than previously projected. The American economy is due to progress by 2.7% in 2010 and by 2.2% in 2011.

In addition to this the markets that initially appear to have counted on a major differential in favour of the USA with Europe - which brought the euro down to 1.20$ - now seem to think that the American recovery will not be as lively as forecast – and this has led to a weakening in the dollar against the euro that has now been fluctuating around 1.40$ since October.

The decline of the euro in the face of the dollar together with the robustness of activity in the emerging countries played an undeniably positive role in the recovery of activity in Europe in the first half of 2010. This stimulating element should now fade if the rise of the euro continues. However the Euro Area's growth has slowly and hesitantly started once more. Countries such as France and Germany are due to recover their pre-crisis GDP levels in 2012. The Euro Area which experienced a contraction in activity of around 4.1% in 2009 is due to record a 1% rise in 2010 and 1.3% in 2011.

The situation remains extremely contrasted between Germany and its main partners. German businesses have taken enormous advantage of the sharp recovery in activity in Asia, of their industrial specialisation that is adapted to world demand and of the period of depreciation experienced by the euro. Also after a 4.7% contraction in its activity in 2009 Germany is now due to record growth of 3.3% in 2010 i.e. double that of the euro area and of France (+1.6%), triple that of Italy (+1%). In 2011 the difference is due to decline but will remain significant (+2% in Germany, +1.5% in the Euro Area, +1.6% in France, +0.7% in Spain, +1% in Italy).

Table 1 : Public Debt in % of the GDP

	2007	2010		2007	2010
Germany	65	77	**Ireland**	25	77
France	64	84	**Greece**	96	128
Spain	36	65	**UK**	44	78
Italy	103	119	**USA**	62	93
Portugal	64	86	**Japan**	188	227

Source : IMF, WEO, April 2010 et Eurostat, Spring 2010

Although European growth is weak and unemployment high and together with its structural problems (research, investment …), it is also facing a sharp rise in deficits and public debts. In these circumstances economic policies are forced into adjusting significantly if mid-term activity perspectives are not to be hindered seriously.

Since the work by Carmen Reihnart and Kenneth Rogoff [2], it is now believed that the potential for growth is greatly reduced once the public debt as a percentage of the GDP rises above the 90% threshold, which can

1. 6th October 2010

2. Carmen Reinart & Kenneth Rogoff, This time is different, Princeton, 2009 lead to increasingly unfavourable situations. The USA will be at this kind of level in 2010-2011 and Europe that fluctuates around 80% on average is due to reach 90% GDP debt in 2012-2013.

This is why establish economic policies must be established to focus on an effective reduction in deficits and the mid-term stabilisation of public debt/GDP percentage (cf. table 2) in all Western countries. The Euro Area countries are not in the tightest situation. Hence according to simulations undertaken by the OECD [3], in the spring to achieve stabilisation of the public debt in terms of the percentage of the GDP by 2025 the USA will have to achieve an adjustment of around 10% of the GDP. Likewise the UK will have to commit to a multi-annual deficit reduction programme slightly lower than that of the USA but much higher than that of the Euro Area.

Tableau 2 : Investment required to stabilise the debt/GDP ratio by 2025

In % GDP	Financial Balance Public Ad 2010 m	Structural Balance 2010 (1)	Structural Balance necessary for the ratio debt/GDP in 2025 (2)	Investment necessary(2)-(1)
USA	-10,7	-7,1	2,6	9,7
Japan	-7,6	-5,0	3,6	8,6
UK	-11,5	-5,7	3,1	8,8
Germany	-5,4	-1,2	1,2	2,4
France	-7,8	-3,2	1,7	4,9
Italy	-5,2	1,8	3,2	1,4
Spain	-9,4	-5,2	0,6	5,8

Source: Economic Outlook OECD, May 2010

The Euro Area will face a significantly lighter task in terms of adjustment. A country that has been as weakened as Spain will have to make an investment equal almost to 6% of the GDP, which is still quite high but not impossible. We should remember that the Spanish public sector produced a 2 point GDP surplus before the crisis and carries a debt that is 20 GDP points lower than the European average. Spain is especially affected by the burden of private debt. In France, the investment required is estimated at 5% of the GDP which represents around 100 billion €. Due to an extremely well controlled financial situation prior to the crisis Germany has to make a significantly smaller effort to reach stabilisation (2.4% of the GDP). With a structural surplus (+1.2% of the GDP) Italy seems to be in the best position in terms of the investment to be made but its debt is 20 points higher than Germany. At nearly 120% of the GDP stabilisation will demand considerable investment over a longer period of time in order to initiate a decrease in its debt to reach the European average.

2. WIDESPREAD DEFICIT REDUCTION POLICIES AGAINST A BACKDROP OF REDUCED GROWTH

Generally European governments have set a target to bring deficits down to 3% of the GDP in two to three years time.

Germany is in quite a favourable position to succeed since it had both a respectable growth rate and good control of its public accounts during the turbulence and as it emerges from it. Its deficit which was not above 3.3% of the GDP in 2009 is due to rise to 4.5% in 2010; this is still quite modest in comparison with the rest of the Western world and the European Union. Germany should finally limit its deficit in 2010 to 60 billion € instead of a previous forecast of 80 billion. The target set by the German government should therefore enable the country to achieve a deficit equal to 3% of the GDP as of 2012 (- 4% in 2011, - 2% in 2013, - 1.5% in 2014). We should recall that in line with constitutional rules the German deficit cannot rise above 0.35% of the GDP as of 2016. The public debt in percentage of the GDP will continue to grow but at a moderate, controlled pace (79% in 2010, 80% in 2011). The credibility of Germany's economic and finan-

3. Economic Outlook OECD, May 2010

cial strategy has enabled it to record the lowest rates on State borrowing in the Western world (2.2%).

Faced with lower growth rates and more vulnerable financial situations Germany's European partners have a particularly difficult task ahead of them. Like many European policies the draft French budget is "historic" according to French Budget Minister François Baroin. In 2011 the public deficit will be reduced by slightly less than 2 GDP points falling from 7.7% in 2010 to 6% in 2011. Without being as vigorous as in Germany French growth will achieve a respectable level (+0.7% in the second quarter) which leads the French government to believe it credible for a return to a 3% deficit in 2013 and 2% in 2014. With this public debt in percentage of the GDP is due to rise moderately in 2011 and 2012 (86.2%, 87.4%) before starting to decline in 2013 and 2014 (86.8%, 85.3%).

In the other Euro Area countries the effort to be made will be greater than in France. In Spain public spending will decrease by 8% in 2011 (a 5% reduction in salaries for civil servants) to achieve a deficit equal to 6% of the GDP in comparison with 9.3% in 2010. As in France, Spain is targeting a 3% deficit in terms of the GDP in 2013.

Italy, which recorded a deficit equal to 5% of the GDP in 2010 and because of the debt burden did not launch a recovery plan in 2008-2009, however it did opt for an austerity plan totalling 25 billion € last July. Like its partners the Italian government is aiming for a rapid return of its deficit to 3% of the GDP. This goal is due to be reached in 2012 after 3.9% in 2011. Even exterior to the Euro Area European governments are committing to extremely vigorous financial stabilisation programmes. David Cameron's new government in the UK has just put forward the most austere budget in the EU. Hence it is planned to bring a deficit that is equal to 11% of the GDP in 2010 down to 1.1% in 2016, which means £99 billion in cuts in State spending over six years: most ministries are to reduce their spending by 25%. Over the same period revenues are due to rise by £29 billion.

3. A TENSE SITUATION IN MOST EU COUNTRIES

In a context of financial austerity such as this most European governments are already or are in danger of facing tense domestic situations because of the sensitivity of public opinion to the effort that has to be made – whether this implies financial stabilisation or structural reform (retirement pensions, labour market).

The danger of tension within the Union can be seen in the potential developments in unemployment rates. Except for Germany which to date has recorded a decline in its unemployment rate due to vigorous activity– (6.7%) European countries are experiencing an unemployment rate of around 10% [4]: 8.3% in Italy, 10% in France, 10.6% in Portugal (9. 6% in the EU and 10.1% in the Euro Area).

Those States that are still suffering the effects of the collapse of the bank and real estate bubbles are experiencing even worse situations than their neighbours where the financial crisis mainly involves the public sector. Spain's situation is extremely mediocre with an unemployment rate of 20.8%.

In Ireland where the banking sector continues to be in considerable danger the public deficit has reached 32% of the GDP according to recent government reports. In this country which is the only Union country where activity continues to contract (-3% in 2009, -2.7%, -1.1% in 2011) the unemployment rate has reached 14.1%.

Finally and generally from a social and political point of view governments have to face the feverishness and discontent of public opinion that finds it hard to understand that finally the burden of the financial crisis has been passed on to them even though events do not seem to be directly related.

4. SUCCESSFUL CONTROL OF THE FINANCIAL AND MONETARY CRISIS SHOULD HELP TO REVIVE EUROPEAN BUDGETARY POLICIES.

Europe can be proud of its undeniable success in solving the bank crisis in 2008-2009 and that of the euro in 2010. The European Central Bank's calm and sense of reality enabled the stabilisation of the markets. The ECB's deployment of unconventional techniques during the crisis at the end of 2008 and at the beginning of 2009 made it possible to inject the markets with liquidities in a widespread ambiance of interbank mistrust.

During the euro crisis in May 2010 the ECB succeeded in reassuring the markets over the sovereign risks in the euro area by accepting public securities in its operations. The operations undertaken by the ECB were finally modest (0.5% of the GDP) if we compare the situation against the effort the Bank of England had to make (14%

4. *http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-29102010-AP/FR/3-29102010-AP-FR.PDF*

of the GDP). The governments did not remain trapped and found a solution to the Greek crisis and to the States' no bail out ban set by the Stability and Growth Pact. Europe showed creativeness, solidarity and credibility. The euro war took place and Europe won!

The Financial Stabilisation Fund established on 7th June last bringing together the 16 members of the Euro Area was convincing as far as the strength of the Monetary Union – comprising the States which are members of it - was concerned. The three main ratings agencies (S&P, Moody's and Fitch Ratings) attributed the fund with the best rating (AAA) at the end of September. The European banking system recovered its credibility with "Basel 3" rules which will make it possible to strengthen its own funds over a more adequate period of time. Hence the crisis made it possible to demonstrate the value of a community response as Renaud Dehousse [5] recently pointed out.

Given this the successful settlement of the financial crisis should help towards favourable budgetary development. No matter how the Europeans compared the situation against their own political culture they now see how dangerous it would be to leave the Stability and Growth Pact as it stands. The crisis has finally convinced them – including the Germans – that the situation would not have become so serious but for the flaws in the Pact which bears a significant share of the responsibility in the divergence of budgetary policies over the last ten years because it is exclusively based on national decisions that are completely void of any real constraint. The lessons learnt during the crisis have had their effect: the issue can no longer be avoided.

European ability to define a joint idea and procedures with regard to piloting national budgetary policies is now a priority. Issues relative to budgetary "federalism", to the role played by the Eurogroup which comprises Euro Area Finance Ministers will have to be addressed in line with the States' extremely diverse degrees of sensitivity.

The community institutions have launched major, innovative initiatives. The proposals made by the Commission in September and October which would increase the role it plays in the macro-economic surveillance of States and the possible application of "*automatic*" sanctions were the source of lively protest – first and foremost on the part of France. The Working Group [6] piloted by Herman Van Rompuy is also actively looking into the issue and is trying to find a balance between the Commission and the big States whilst the latter do not want to allow the community institutions to take over the final definition of a doctrine and hope to retain the control of the process and over such vital areas.

Possibly apart from an "*apparent*" opposition between the Commission and the States the crisis has also increased the need to increase the weight of politics in the European process.

5. THE FRANCO-GERMAN ENGINE – KEY TO THE SUCCESS OF THE VITAL REFORMS

Although Europe can be pleased at having mastered the banking and the financial and monetary crises that were probably the worst since the signature of the Rome Treaty in 1957 it owes it to the States' ability – notably France and Germany – to find dynamic compromises based on ideas that a priori were incompatible. Awareness of the extent of the risk being run finally won over the differences in opinion that existed on either side of the Rhine.

In these circumstances it is vital to create a "*dynamic*" that is part of a continuous process. At present it is difficult to imagine "*a major convergence*" in budgetary policies. This process, which can only be developed in stages, basically depends on two conditions.

The first is to create an agreement between the "*big*" States. If Europe is still vulnerable – notably in the eyes of the markets, - this is largely due to the financial situation of the major States from an isolated and concurrent point of view. It is the ability to form an agreement or at least a joint doctrine between Germany, France and also other major euro area States for the misunderstandings between Europe and the markets to disappear completely.

The second involves the role played by the Franco-German couple – which is decisive in this type of development. The common position established by Angela Merkel and Nicolas Sarkozy on the sidelines of the Deauville Summit on 18th and 19th October is a cornerstone on which the 27 can base the continuation of the budgetary policy reform process using the ideas set out by Herman Van Rompuy's Working Group.

In the opinion of the Franco-German couple – as expressed in Deauville, the States' financial solidarity would be enhanced and include "*a strong, permanent mechanism to guarantee an organised approach to crises*" as well as the "*necessary arrangements*" to enable

5. Renaud Dehousse La méthode communautaire à l'épreuve de la crise, in CEPII L'économie mondiale en 2011, La Découverte, Collection Repères, September 2010

6. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf

"*Member States to take adequate, coordinated steps to safeguard the stability of the euro area,*" which would mean de facto relinquishing the bail-out ban that is included in the 1997 Stability and Growth Pact. The two governments also came to a compromise on the way sanctions should be applied, the automatic nature of which would be made more flexible and would occur as a last resort. Likewise France aligned itself with the German idea of aiming ultimately to deprive a State of its voting rights. A vital point in the Franco-German discussions was that the piloting of economic policies should not be limited to the management of the deficit in percentage of the GDP (3% in the Treaty) but that it should also include the level of public debt in relation with the GDP (60% in the Treaty).

The Europeans who met in Brussels on 28th and 29th October [7], agreed on greater State budgetary control on a community level, on doctrinal convergence that was included in Herman Van Rompuy's report together with the six monthly coordination of national parliamentary procedures. But under Franco-German impetus they went further than this. They finally accepted – in spite of their initial reticence to review the Lisbon Treaty to enable the long term existence of the European Stabilisation Fund beyond 2013 – without which a constitutional obstacle would be encountered in Germany and fears on the market would be rekindled with regard to the States' financial strength.

However the political sanctions that were requested by Germany and supported by France as part of the compromise defined in Deauville - notably the suspension of voting rights - met with strong opposition on the part of a certain number of States as well as the Commission. Given this Herman Van Rompuy will continue his study to bring about convergence between the 27 during the next European Council in December.

7. *http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/fr/ec/117509.pdf*

AN EXIT TO THE CRISIS IN THE SHAPE OF A REASONED STRATEGY?

As for others the crisis involves an inextricable mix of risks and opportunities for Europe. The lessons of the crisis have had their effect: Europeans have become aware, the Greeks as well as the Germans, of how solitary behaviour can ultimately prove more costly than joint responses. This diagnosis applies both in the early and later stages.

In the later stages solidarity offers the necessary power to contain financial storms. Early on it offers the means for more stable, sustainable and higher growth.

The pertinence of community solutions has been proved to be even more fitting in a time when emerging from the crisis has been difficult and uncertain, precisely because the path to credible growth seems such a narrow one. Except for Germany European countries seem to be destined to suffer reduced growth and significant public debt long term. The undeniable success of controlling the turbulence in the banking and monetary sectors over the last two years must convince the States in the Euro Area that they should not be discouraged in the face of the slow development of a common doctrine based on diverging economic ideas and results.

Unlike previous situations Europeans must adhere to this goal to a greater degree and draw up their own growth strategy that goes beyond the reduction of economic pressure since it seems illusory to count on the rapid recovery of the American economy. The USA, the epicentre of the financial earthquake of 2008, is labouring under a public debt that is far in excess of European standards and which in reality will burden the return to comparable pre-crisis growth for a long time to come.

Will the Europeans be able to see their way out along this narrow path which they have no choice in taking?

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