FONDATION ROBERT SCHUMAN

POLICY PAPER

European Issue
n°191
17th january 2011

How do we return to a predictable European economic environment?

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SUMMARY The crisis has plunged the European economy into an 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 Union. European governance has to be reformed in this sense and a certain number of vital decisions have to be taken so that uncertainty about the economy is not also accentuated by political and legal uncertainty. These decisions involve statistical information, budgetary supervision, default risk management of States and banks, the support of investment as well as the external stability of the euro. Only a clear, credible response to these various issues would favour a return to a situation where the economy can function normally, i.e. a return to a situation in which risk is predictable, measurable and does not discourage investment.

INTRODUCTION Since the financial crisis began the European economy has faced uncertainty which has fed the recession, caused panic on the financial markets and worsened the debt crises in several Member States. It now 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 full 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 not succeeded in coordinating effectively either the recovery or the austerity plans. The Council has delayed in setting up an assistance mechanism for the States that were in danger of collapse and is also delaying in agreeing on the creation of a mechanism for the management of sovereign default. The European Central Bank (ECB) was not explicit with regard to the future of its quantitative easing policy and about the purchase of bonds of governments struggling on the secondary market: it admits to being divided over which policy it should adopt.

Gradually European political decision makers have 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?

WHAT SHOULD BE DONE ABOUT THE DEBT?

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-1990 on the developed western economies lived under the illusion that the "*Great Moderation*" [2], a period of decline in macroeconomic volatility, would be sustainable. This stability even made economic players sufficiently confident

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.

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. Investment banks believed therefore that they could build models based on hypotheses in which the probability of exceptional events was almost nil, thereby reducing equally both the risk of calculated illiquidity and default. Households and businesses, notably in the US and also in a certain number of European States fell into unprecedented levels of debt. In 2007 private debt soared to 378% of the GDP in Ireland, 306% in the UK and even 216% in Spain [3]. States were also able to borrow cheaply: several Member States accumulated deficits in spite of the Stability and Growth Pact rules; others, whose debt was already considerable, slacked in their efforts to reduce their debts.

This apparently calculable period of risk suddenly came to an end with the crisis which 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 enjoined to recapitalise the banks and to 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: within the euro area the Greek crisis revealed the reticence of certain public opinions to help States which had not been very exemplary in terms of their macro-economic management [4]. Conversely the Irish crisis revealed the humiliation felt by a country when it receives conditional aid and the ensuing political crisis it is often associated with.

The emerging economies, which prior to the crisis had little debt and enjoyed a greater potential for growth recovered quickly. The economies in the West which had to decrease their debt had to face a brutal slowing from which they are struggling to emerge. The financial markets are worried to a varying extent depending on the country. For the time being the US is protected from speculation whilst its deficit and public debt are far beyond those of the Euro Area (11.1% and 92.7% respectively in the US in 2010 against 6.6% and 84.7% in the Euro Area), due to the confidence that investors have in the dollar. Within the Euro Area the financial markets are again distinguishing between the debts of the various Member States. The resulting speculation is increasing interest rates on the sovereign debt of the struggling States and sometimes this rises to unbearable levels when the payment of interests compromises the reduction of the deficit.

Aid to other States by the Euro Area and the IMF has therefore become vital but this measure faces several hurdles. The first lies in the financial fragility of the States that provide the funds because this fragility 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 one another. The result is an inadequate level of unity and coherence in the discourse and action taken by the Member States. 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 they can 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. 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.

Given this situation 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 [5] 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 [6].

3. On this point see Jean-François Jamet and Franck Lirzin (2009), "Europe and the Recession", European Issues – Robert Schuman Foundation Policy Papers n. 130.

4. See Jean-François Jamet (2010), "German Ethic and European Spirit: Can Germany guarantee the euro's stability?" European Issues - Robert Schuman Foundation Policy Papers, n. 182.

5. 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

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

Information is indeed a key element to counter uncertainty. The opacity of Greek accounts together with the tacit approval of the Council must no longer be possible. The credibility of the Euro Area is at stake.

• 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. And so the stress tests 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 forward 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 seems 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 and also thanks to the supervisory and sanction measures included in the legislative package which the Commission presented in September.

• It is not very realistic just to count 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 combined intelligently 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 to the subject. Then the implementation of an orderly default mechanism would reassure the financial markets of the European Union's ability to face this kind of possibility: 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 defining an emergency negotiation framework with the States' creditors. Several proposals have been put forward [7], including by the Eurogroup on 28th November 2010. In fine, the creation of a European Monetary Fund [8]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 once more. It must therefore have an investment strategy [9] to complete the EU2020 strategy thereby making it tangible. 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 [10] and making better use of the cohesion funds for the temporary support of investment in the countries that are experiencing the most severe recessions and which are suffering tight restrictions in terms of public finance. In this way the previous failures of the IMF's adjustment programme in which stabilisation killed off growth because it compromised investment can be avoided. 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 to provide support to one of the vital elements of Europe's potential growth. Moreover if this investment is used intelligently it might also lead to a strengthening in the two other pillars i.e. human capital and general output with regard to the factors of production.

WHAT ROLE FOR THE EURO?

Given the profound uncertainty experienced at present by the Euro Area the single currency is not the focus of debate but is seen rather as a potential victim or an adjustment variable. In the wake of the Greek

7. 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.

8. 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.

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

10. 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.

crisis its future was brought into question; Europeans themselves have rather a negative opinion of it [11], the Council has not defined any exchange rate policy and the Euro Area does not have any external representative. However the euro is vital for the stability of the European economy and fosters trade. Without it Europe would, in all likelihood, engage on a disastrous negative downward spiral in exchange crises (as in 1993), devaluations (as in the 1980's) and protectionist backlash (as in the 1930's).

In a time of crisis it is natural to think that everything would be better in a different world, in this case without the euro. Hence many observers have pointed out that a flexible currency makes depreciation possible in a recession because it enables the return of competitiveness [12]. But this does not take into account that the present crises in the Euro Area are not just about competitiveness but also debt, which is particularly advantageous to speculation on currency. It is highly likely that either Greece or Ireland would have experienced a far more serious crisis without the euro, as was the case in Iceland: the sudden depreciation of the currency during a crisis increases the severity of the debt crisis because of capital outflow and of a rise in the debt if

it is denominated in foreign currency. It is only subsequently, often once the economy has collapsed, that depreciation facilitates recovery. Although the euro could not prevent the excesses and imbalances that caused the debt crisis it prevented the complete collapse of these economies and limited the related effects of contagion.

The euro is in itself therefore an instrument of internal stability in spite of the difficulties experienced in coordinating the economic policies of the Member States that compromise it. It still has to become an instrument of external stability. In ten years the euro has certainly succeeded in asserting itself as the second most important international currency alongside the dollar. But it is marked by high volatility vis-à-vis the main currencies (the dollar, the yuan, the yen and the pound sterling), which is detrimental to European exports and investment in Europe. One of the Euro Area's main goals must be to reduce this volatility and turn the euro into an instrument of external stability. This means the gradual establishment of a "*euro diplomacy*" . In the face of the currency war which involves two antagonists for the time being, China and the US – the outcome of which will determine the macro-economic balance for the next decade – the Euro Area has to provide itself with a common external representation whose job it is to stabilise the rate of the euro and reduce world macro-economic imbalance. Indeed it would be absurd if the Euro Area were to stand on the sidelines of this non-cooperative international game and if it did not attempt to reduce the volatility of exchange rates of which it is the main victim since the yuan and the dollar remain aligned. "*Euro diplomacy*" [13] could work according to the model of the European trade policy, i.e. on the basis of a mandate given by the Eurogroup to its Chair in view of it participating in international monetary negotiations. An intermediary stage might comprise France and Germany speaking with one voice on this and even sending one representative to the negotiation table involving the responsible international bodies (G20 and IMF). Alternatively the countries which share a similar monetary culture in the Euro Area (for example Germany and the Netherlands) might also adopt a similar approach.

To stabilise exchange rates several possibilities offer themselves. The drawback of an "*international currency snake*" or of a return to the "*gold standard*" is their rigidity; they would also be the cause of conflict in terms of the exchange parities. Another option would be to make the emerging countries aware of their responsibility – notably in Asia – by suggesting they peg their currencies against a basket of currencies (and not just against the dollar) and gradually increase the value of their currency vis-à-vis this basket [14]. The latter might include the dollar, the euro, the yen for example and possibly the pound sterling and the Swiss franc – weighted according to each of the corresponding monetary zones in the trade of these countries. A policy like this would be advantageous in many ways. Firstly it might be undertaken progressively which would facilitate political agreement and thereby avoid a brutal shock for both the emerging and developed economies. This policy would in turn answer the concerns raised by various countries. Since the dollar would not be the only value of reference it would depreciate gradually – as Washington would like to see. China might end its conflict with the US and diversify the composition of its reserves, thereby limiting their loss in value long term

11. On this point see recent survey results e.g. by the German Marshall Fund of the United States (2010), "Transatlantic Trends 2010", (www.gmfus.org/trends/doc/2009_English_Key.pdf).

12. See for example Gilles Saint-Paul, " Is the euro a failure?", Vox, 9 May 2010 (http://www.voxeu.org/index.php?q=node/4999).

13. On this point see Franck Lirzin, "Which diplomacy for the Euro?, European Issues –Robert Schuman Foundation Policy Papers, n. 92, 2008.

14. On this point see also Stefan Collignon, "Does the European Union have an external economic strategy?" The State of the Union 2010. Schuman Report on Europe, Paris, Lignes de repères, 2010 pp. 77-89.

in spite of their initial depreciation. A currency basket would also fulfil China's desire to internationalise progressively the renminbi in view of making it a global reference currency. The renminbi would play a key role close to that put forward by the Chinese in view of a new Bretton Woods. The Euro Area and Japan would also see a decline in the volatility of their currencies against the renminbi and the dollar to the advantage of their export industries. The gradual appreciation of the emerging currencies vis-à-vis the currency basket would limit the danger of an over appreciation of the euro vis-à-vis the dollar and it would be compensated by the depreciation of the euro vis-à-vis the emerging currencies. Moreover the inclusion of the euro and the yen in this basket would lead to the investment of a share of the Asian reserves in the Euro Area and Japan thereby facilitating the funding of their debt and recovery. The difficulty of this lies in the need to organise it progressively (to avoid a shock on competitiveness, or on the value of Chinese reserves, as well as an excessively hasty modification in the status of the dollar) and that it must be undertaken as part of a regional cooperation agreement (to avoid for example non-cooperation between the Asian countries). To facilitate this development a regional monetary funds might be created and each would subsequently be represented in the IMF and the G20 [15].

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If "*government means anticipating*" according to Emile de Girardin – government also means enabling economic players to anticipate. But the European economy has 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 and a certain number of vital decisions have to be taken so that uncertainty about the economy is not also accentuated by political and legal uncertainty. These decisions involve statistical information, budgetary supervision, default risk management of States and banks, the support of investment as well as the external stability of the euro. Only a clear, credible response to these various issues will lead to the re-creation of normal operational conditions for the economy i.e. a return to a situation in which risks are predictable, quantifiable and do not discourage investment.

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015. An Asian Monetary Fund already exists. For a more detailed presentation of this proposal see Stéphane Cossé, "Il faut tirer les leçons du sauvetage de l'Irlande", Le Monde, 26th November 2010.

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