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The Euro's Stability : the need for true reform of financial activities

from **Emmanuel Sales**

General Manager of Financière de la Cité

ABSTRACT

Beyond being a monetary zone, the euro is a moral system. This is both its strength and weakness. By setting rigorous plans for a return to balance the authorities have done their duty. But the effort required may result in nothing, if at the same time, there is not a true revolution in the way financial activities are organised and supervised. To guarantee the veracity of the currency over the long term, it is not enough to hold up macro-economic solvency criteria. Traditions of accruing wealth by work and savings must be encouraged and confidence in the financial system has to be restored. This implies joint determination by France and Germany to introduce a better regulation, balancing the banks and ending privileges to financial institutions.

INTRODUCTION

"If the stars should appear but one night every thousand years how man would marvel and stare," said Emerson. Having grown accustomed to the use of the single currency we have neglected it. The euro's self-evidence distracted us from our duties. Like a careless owner we left the defence of our rights in the hands of those who had been given the simple responsibility of its management.

The financial crisis has reminded us of our obligations.

For the last thirty years, the credibility of the Central Banks and the efficiency of the sovereign debt markets have maintained the illusion that economic cycles were under control. Rising asset prices concealed growing imbalance. The global financial crisis revealed the gulf between the real value of things and what people had imagined.

Since then the situation has not improved. The US is now committed long term to policies that aim to depreciate the value of the dollar at the risk of creating price tension. The financial sector has placed itself under the States' wing, without changing any of its practices. Increases in governments' national budgetary spending mean that indirectly, ordinary, honest men have to suffer the entire burden of economic adjustment.

In these extraordinary circumstances, the European authorities have shown financial wisdom and political courage. By guaranteeing the rescue of struggling countries, they opened the way for budgetary policy integration. By not embarking on a chaotic cash injection policy, they protected the currency's value.

But this is not enough.

Beyond being a monetary zone, the euro is a moral system. It is founded on the confidence and education of those who use it. If the euro is to establish itself long term everyone has to be sure that no one – either by unilateral policy or any type of privilege - can have more than his due. Quite logically, the return to balanced public accounts necessarily means an in depth reform of financial activities.

THE EURO IS A MORAL SYSTEM BEYOND BEING A MONETARY UNIT

Gauging the euro zone against purely accounting and financial criteria is one sided in that it omits vital elements of its history. Indeed, the populations of the euro area have a shared past which includes all of the features Wittgenstein called a "form of life", a link to law and history that defines speech and behaviour.

The euro is the legacy of the great European civil war

Unlike the English and the Americans in many ways euro zone members are resilient populations. Their land and cities bear the scars of the greatest world conflicts; they have suffered dictatorship, totalitarianism and the Soviet Ice Age. Of this there remains a certain mistrust of ambitious policies, a multilateral vision of the world and a preference for a balance of power reflected in European integration itself, forged by negotiation and compromise.

In their wisdom some say that the euro is an artificial creation. What is rather surprising however is that we used the franc, the mark, the lira etc ... for such a long time. The corruption of the currencies after the Great War was the key factor in the social and political collapse of European society. From 1914 until the introduction of the euro in 1999, the value of the French franc was divided by twenty; the mark collapsed twice, the lira and the peseta became practically worthless. On every occasion the monetary policies that followed a return to peace led to deficit, national withdrawal, a reduction in demand and the impoverishment of the majority.

The euro put an end to this long saga. In theory, with the euro everyone is guaranteed "to have his rights fulfilled" according to the old legal expression taken up by Rueff. The euro is based on the simple, common sense idea that every European can draw on the wealth of the market "up to the amount that he pays in". The value of the single currency stems from the Member States' commitment to follow common rules, which they laid down themselves and not according to some vague hereditary privilege enabling acquisition without payment. This is both its weakness and also its force: the Greek State's creditors' rights are certainly below par rating but they are nevertheless real rights. Can the same be said for the creditors of the American Treasury?

Savings are the basis of monetary stability

Household savings are the other key to monetary stability. Although the euro zone was less affected than others by the financial crisis, it owes this less to the clairvoyance of its elites than to the level of its citizens' education. Former IMF chief economist, Raghuram Rajan, observed this. A distant origin of the crisis lies in the failure of the American educational system. Instead of encouraging people to save, the American authorities have spurred on penniless households to become the owners of their own property.

The situation in Europe is quite different. According to the OECD the gross rate of household savings in the euro zone represented nearly 16% of their available income, against barely 4% in the US. The rise of consumer credit and mortgage loans is a recent phenomenon and is extremely confined, mainly to some countries in Southern Europe. Generally, financialization mechanisms of illiquid assets and notably real estate, which some approved of just a few years ago, never became firmly established in Europe.

Bastiat remarked that in Europe enjoying leisure time, perfecting the arts and intellectual and moral development have always gone hand in hand with the patient accumulation of capital. Citizens of the euro zone, who are burdened with little debt, have financial resources at their disposal which have enabled them to survive a major part of the macro-economic crisis. This is why the period of contraction in the euro zone will be shorter and less painful than elsewhere.

Under these conditions the sovereign debt should be relativised. The financial problems experienced by some Member States since the end of 2009 are related to the poor governance of their financial sector (as in Ireland), to policies that have encouraged private debt and the deregulation of credit (as in Portugal and Spain), and to the poor management of the State (as in Greece). However traditions of accruing wealth by work and savings are firmly established in civil society.

Contrary to the articles that are constantly published in the Financial Times, the euro is not a "Ponzi Scheme". The global crisis that started in 2007 should be used instead to strengthen the euro's foundations, which are confidence – that obliges us to live and circulate in a common space – and education – which has taught us not to spend what we have not yet earned. From this standpoint there are several possibilities open to us, which closer cooperation between France and Germany would help to make a reality.

EUROPE HAS TO SET ITS OWN MODEL FOR FINANCIAL REGULATION

Promoting long term saving

Rather than artificially supporting consumption by satisfying various clienteles, on the contrary, savings must be channelled towards long term use. Only those with substantial resources resulting from the size of their own funds or their stable liabilities can confront the perils of the long term, without succumbing to the moral hazard involved. Long term challenges, particularly those involving life expectancy (retirement, long term care) the funding of heavy industrial risks (such as the dismantling of obsolete nuclear power stations) have to be borne by those who are able to do so.

In this respect the new solvency requirements applicable to insurance (the so-called Solvency II) are, in our opinion, a monumental error. Based on a totally statistical approach to short term financial risks, they are a serious handicap to insurers' ability to shoulder the burden of long term needs. Economist Christian Gollier, who was directly involved in revising the discount rates for public investment in France and abroad, recently made the following comment: the adoption of a reform that so obviously favours the short term is surprising, whilst it is long term challenges such as increased life expectancy that weigh so heavily on our collective future and public debt.

In this sense we can but call for the European authorities to take heed. Amongst the players in the financial system, insurers naturally enable the pooling and transfer of risk over time. Unlike the banks, they play a key role in long term risk management. Rather than fostering the transfer of financial risk over to private parties, mechanisms of collective solidarity should be encouraged; hence savings would be channelled towards the funding of infrastructures or long term requirements, which today are borne by public debt.

Downsizing banks

European regulators will have to undertake a true Copernican revolution. Financial regulation is there to protect savings and to counter fraud and not to prevent the bankruptcy of banks, notwithstanding the moral hazard and misappropriation of public money that this implies. Risks of contagion of the entire economic system have to be anticipated by preventing establishments from taking undue correlated risks, and from adopting unsound balance sheets.

In this regard financial establishments and their level of involvement with the public sphere are now a problem. Access to State funds enables financial establishments to work with intermediaries, who opaquely expose them to bankruptcy. Moreover, the weight of financial institutions allows a small number of players to hold sway over standards policies.

Here the requirements of financial stability match public interest. Establishment downsizing must go hand in hand with a clarification of the role of regulatory bodies, which cannot both supervise and promote financial markets. There is still a great amount of work to be done given the direction taken in terms of regulations over the last few years. However Germany and France are influential in Europe and have enough weight to guide regulation in a direction that is more in line with investor interests. It is simply a question of political will.

Guaranteeing the strict separation of financial activities

Similarly the authorities might also establish a European "Glass Steagall Act" (from the name of the law that established a strict separation between the activities of merchant banks and savings banks in the US) to ensure that banks' and their clients' interests coincide.

How can one establishment make savings, advise businesses, issue securities and quite independently manage the savings placed in its hands? Apart from the conflict of interest that it raises, the banks' practice of channelling financial flows according to their balance sheet requirements leads to a poor allocation of savings long term. Common sense, just like economic theory suggests a separation of the two professions, ie banks and insurance, the savings banks and the merchant banks, third party asset management and own account management.

In this area there is also still a great deal to be done. Administrative tradition privileges the emergence of large establishments which offer apparent guarantees in terms of risk management and offer attractive solutions for the careers of high ranking civil servants. Under the impetus of Paul Volcker, former Chairman of the American Federal Reserve the US started to set rules that aimed to safeguard against conflicts of interest. France and Germany could go further by imposing a real separation of financial activities.

Adopting counter-cyclical standards

The financial crisis revealed the negative effects of the procyclicality of prudential standards. In times of stress, the instant decline of indicators encourages the auction of assets and leads to liquidity hoarding, at a time when decreasing interest rates would allow for increased risk taking.

Unfortunately, not much has been learnt from the crisis in this area: the ratings agencies have gathered strength, short term risk parameters have been extended to the entire financial sector. Quite clearly new means to gauge financial balance that move towards a counter-cyclical approach have to be put forward. With the aim of covering long term commitments in mind thought has to be given to the macro-economic effects of the posting of assets into market value. Likewise, work by the Basel Committee to put an anti-cyclical buffer capital together for banks in times of growth, have to be given support.

CONCLUSION

The global financial crisis, ongoing since 2007, provides a great opportunity. Unlike the US, Europe is committed to monetary stability. It has hedged its bets on the fact that socialisation will win over divergent trends that have led to impoverishment and dependency. It is a demanding and yet reasonable choice. But the effort required may result in nothing, if at the same time there is not a true revolution in the organisation and supervision of financial activities. Who cares about codes of good behaviour and audit risk procedures if the powerful cannot fail? If we want to establish the credibility of the currency over the long term the solvency of the economy and the financial system has to be re-established on sound foundations.

Author : Emmanuel Sales

Alumni of the Ecole Normale Supérieure (Ulm) and agrégé in philosophy. General Manager of Financière de la Cité.

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