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The Agencies give ratings, Europe is moving forward

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ABSTRACT

The downgrading of the euro zone States' rating by Standard & Poor's on 13th January last did not rock the markets as it had been feared. The basic meaning of the message in October was not the only thing that they took on board when the agency announced that it was placing France under surveillance. To date the markets have accepted the European strategy set in place after the Council on 9th December 2011, which aims to combine national financial consolidation and European financial solidarity. This plan seems to be the necessary condition to lead the euro zone towards budgetary integration, which is coherent with the States' choice to use the same currency. In this process France seems to be the decisive link due to the driving role played by the Franco-German couple. Germany does not want to lead Europe alone, and it wants even less a "German" Europe. France and Germany both enjoy the critical mass to take the entire euro zone forwards. France is therefore a decisive link in the ongoing process; it is vital for it to continue with its financial reforms and to increase its competitiveness. The forthcoming presidential campaign is therefore quite risky: the markets are keeping it within their sight.

The downgrading of most of the euro zone States by Standard & Poor's (S&P) on 13th January simultaneously triggered off a political storm and revived fears over how the markets were going to take on board the new sovereign debt ranking, with Germany now reigning over the euro zone amongst its "downgraded" members. Most governments in fact believed that the work undertaken in the autumn of 2011 would calm the ratings agencies. Their hopes were in vain.

With regard to a subject like this the ensuing political turmoil would be of surprise to no one in a pre-electoral period and, all things being equal, as the following chapters in the financial saga illustrated, there was a kind of over reaction to the event. However the glaring difference between the calm of the markets and the agitation of the politicians should not mask the nature of the issue set by the downgrading of the debt rating of the euro zone States, which goes beyond the present economic situation. Political leaders for their part should not just complacently bathe in the relief of having suffered a close shave: the battle to be fought will not be any less difficult.

Much ado about nothing?

From a financial point of view the downgrading of France's ratings – the loss of the triple A – as was the case in most of the other euro zone States, was information that the markets took note of but their appreciation of the States' financial position is not just limited to that; in other words they do not follow each other blindly. It is significant to note that not all of the agencies reacted in the same way: France still enjoys Moody's best rating. The reason behind S&P's new assessment is not of an unquestionable logic either: one cannot demand steps to correct deficits and at the same time deplore their effects short term on growth. Once a State, a business or a family, decides to do everything it can to reduce its deficits and debts, it cannot also consume or invest at the same pace. The contradiction only finds explanation if we interpret the message as an appeal to the Central Bank for monetary action similar to that undertaken by the Federal Reserve or that of the Bank of England. If this were the case S&P's assessment would certainly not deserve a high rating: firstly, unlike the USA and the UK, the euro zone States' budgetary integration has not achieved the same level as monetary integration; then, by looking for the solution to the problem in stimulating inflation, incentives for budgetary consolidation and reform would decrease. For the last twenty years the USA has been moving from the explosion of one bubble to rise of another; Europe is right not to adopt this kind of strategy.

The calm after the autumn storm

However the messages addressed to the States and notably to France should not be ignored nor should their effects be underestimated. There are two messages to heed: the euro zone is suffering the shortcomings of its integration, which the crisis has now brought to light; the asymmetry in the economic and political status of France and Germany is the cause of serious problems at a time when Europe's budgetary integration relies heavily on the Franco-German motor's ability to drive matters forward: it will not really work if differences in economic and financial status are too great. It is certainly inappropriate to designate France as being, a or the, weak link in the euro zone; it is the decisive link since all of the crisis transmission vectors and the settlement of this pass via Paris.

With regard to the shortfalls in euro zone integration, the successive European Councils of the last six months, and notably that of 9th December last, have shown how the will to address the consolidation of States' financial policies must go hand in hand with an enhanced integration process, notably thanks to increasing financial solidarity between the States, which is clearly shown by the long term establishment of financial solidarity instruments (EFSF, ESM) in euro zone integration. By definition in a process of change, the optimists and the pessimists believe it vital to stress the pertinence of their view of the situation. It seems that the markets have accepted to presume in the States' credibility. Whilst after Brussels, columnists started pessimistically to exaggerate about the ability of the States most exposed to the rating agencies' critical eye – Spain, Italy, France – to raise funds on reasonable terms, their issuance rates eased off in comparison with previous market operations and forecasts. These signs on the part of investors could strengthen the strategies launched by the most indebted States. Moreover, since it is never certain that the worst will happen, healthy activity that continues in Germany without any Keynesian stimuli, together with a sharp contraction of its deficits, provides a stabilising element to the euro zone's general state of balance. The message sent out by Germany, which associates financial discipline, increased competitiveness and better living standards would, via collective discipline and the lessons to be learnt with it, comprise a strengthening factor to work done by all States in the euro zone.

France, a decisive link in the euro zone

In these circumstances we can only hope that French political leaders who are about to launch into the presidential electoral battle will use their skills to enthuse the crowds in meetings without increasing uncertainty with regard to France's ability to retain and even to step up its work to reduce its deficits. Maintaining French acceptance of financial discipline via the euro zone is all the more important because, since the first oil crisis and except under Raymond Barre's government, France has almost never succeeded in initiating either financial consolidation or reform, the vital nature of which it is however aware. Moreover the gap in economic standards between France and Germany has reached a limit, which electoral spin will probably reduce to budgetary implications. The markets are aware of this and the ratings agencies will certainly recall, in their own way, that the scenario put forward at the end of 2011 in terms of economic convergence according to a German model depends on ongoing, long term, in depth financial consolidation and structural reform. From this point of view the policy implemented in Italy by Mario Monti seems to be following this kind of model, with the emphasis being on the reduction of spending as a priority, together with structural action on improving the functioning of the economy. France is still advancing too cautiously on this: the announcement made by the French President about social VAT, which will transfer a significant share of labour social charges over to consumption illustrates that, in a similar vein to the 2010 retirement reform, the government wants to place French policy on a long term trajectory, marked by deficit contraction and the strengthening of business competitiveness. The goal pursued by the French leaders comprises both inspiring reform that has provided substantial results in Germany and the quest for greater convergence with its main partner.

The challenge is great: because apart from its national effect, the work undertaken by France places the credibility of the euro zone's consolidation process on the line; holding the capital that totals nearly half of that of the Central Bank and the Financial Stability Facility, together Europe's two main economies have the critical size to pull along their other partners. Market doubt about France's ability to retain its financial position in the facility cannot be compensated for by Germany alone. To this we might add the political dimension, because if the euro zone has to function with a France that has "*fallen by the wayside*" and if it can only rely on Germany's leadership – even if this is economically founded - it will encounter problems in terms of national sovereignty. The now nascent budgetary federalism requires at least a France that occupies the position expected of it. This is why the German government, either by way of Angela Merkel or Wolfgang Schäuble, has made it clear that it does not want a "German" Europe, even if the facts point to this. This is why the

German leaders' encouragement addressed to their French counterparts with regard to their reform plans has been so important.

The markets have accepted the European strategy but it is still under surveillance

Basically the downgrading of the sovereign debts in January was close to a non-event. The real message was delivered in October on the launch of the French budgetary procedure when it was announced that France was under surveillance; since then the gap in the French-German rates has varied around 150 basis points and has put the French authorities under sufficient pressure. At the same time, and as the meetings between the leaders have succeeded each other, the implementation of a process based on the simultaneous strengthening of national budgetary discipline and European financial solidarity is proving to be sufficiently credible that the markets are accepting the moderation of their pressure on governments in the euro zone. The path is a narrow one because blanket policies inevitably impede growth. But at the end of the day, in spite of short term negative effects, the benefit of these will win the day mid-term since the reduction in financial requirements will affect the drain on resources positively in favour of the productive sector. Financial consolidation is the first condition to raising mid-term competitiveness. Again the change should be highlighted: under the influence of the nascent budgetary federalism, national economy policies are moving from neo-Keynesian policies short term towards those which graduate to stability mid-term. Markets and political leaders have agreed on this compromise which reduces the short term influence of the ratings agencies on market behaviour. However the compromise is fragile and anything that might threaten it is potentially disastrous. It is therefore wise not to try to open Pandora's Box, in spite of pressure from the polls and acclamations heard during electoral rallies. In short it is the French presidential election that is under surveillance both by the agencies and the markets.

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