

## BÖLL TEA BRIEFING

### IS THERE A FUTURE FOR THE EUROZONE?\*

*Many a swansong on the euro and the eurozone has been sung during the first months of 2011. Some economists and politicians prophesy an end of the euro(zone) and plead for the reintroduction of national currencies (or, at least for a split of the eurozone allowing the weaker countries to devalue their currencies which, in turn, could boost their exports). But, also, many European citizens (especially of economically stronger countries) want to get rid of the euro and of the discipline of the Eurozone they blame for hard-hitting cutbacks. They want „their own money back“ and they resent making sacrifices for their weaker and „wasteful“ European brothers and sisters. For some the end of the Eurozone and even the European Union is nearby. In the meantime, Estonia has happily entered the eurozone and European leaders and ministers of finance quarrel passionately and work hard to find a solution. Often in the past, Europe was at its best and most creative under the most difficult and threatening circumstances. Will the euro(zone) survive? Are the measures taken so far the right ones and what else needs to be done?*

#### **The nature of the crisis**

The crisis we have been witnessing is not a crisis of the euro, it is a debt crisis. We had a financial crisis, starting in the US after which it moved to Europe. At a certain point in 2010, this crisis became a sovereign debt crisis. First it was about public debt. Then we discovered that it was no so easy to distinguish between private and public debt. Of course, one of the main reasons for the crisis was the situation of the balance sheet private sector, financial sector and the bank sector. Ireland was considered an example for a long time and now we ended up paying for the debts of its banks. What we experienced in 2008-2009 was a very large influx of capital in the periphery of Europe. The problem is that once the influx stops you have a situation where you do not have any more credit. In the case of Greece there was a problem of not assessing properly the fundamentals, whether the debt was sustainable or not.. The fundamentals were telling us that it was sustainable. But when this crisis happened it turned out it was not. The debts kept accumulating with a high risk of insolvency

One of the problems the global financial crisis has exposed in the European economy is the fact that there was no real commitment to reduce public debt. In some Member States booms in housing, construction and financial sectors succeeded in hiding macro-financial imbalances. Now, due to the crisis, public debt in the EU is expected to reach 84% of GDP in 2011 (88% in the Euro area). Also, in some Member States, low financing costs led to the misallocation of resources (high levels of consumption, housing investment and the accumulation of external and internal debt). Especially the construction and real estate sector (and in Ireland also the financial sector) grew out of proportion. In Ireland and Spain alone over the year 2000-2007 40-50% of total of employment creation went into these sectors. In Greece the crisis was mainly due to inappropriate fiscal policy and this made clear that the

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European Union needs a better surveillance mechanism in order to prevent a reoccurrence of such a situation as well as more appropriate tools to defend itself against a threat to the stability of the eurozone.

### **The responses of the European Union**

Europe's responses to the crisis have been swift, pragmatic, effective and comprehensive. When the global crisis started the EU reacted on several fronts almost simultaneously. First of all, a number of major emergency measures were taken to avert the worst. The European Central Bank provided emergency liquidity right at the start to support financial markets. Member States provided guarantees and financial support to safeguard financial stability and prevent financial collapse. The Commission insured critical coordination across the financial single market. With the European Economic Recovery Plan which is almost forgotten because events followed each other so rapidly, the EU put in place a coordinated fiscal stimulus programme to counter the impact of the economic downturn on growth and jobs.

Thanks to all these measures many taken in concert with G-20 partners the world economy escaped a protracted depression. Second, Europe took a close look at the root causes of the crisis and started drawing consequences. This includes a fundamental overhaul of the financial market supervisory and regulatory architecture. One example is the European Systemic Risk board that started working in January 2011 with the purpose to prevent or mitigate risks to the financial stability in the EU.

The crisis brought to the core the four most essential gaps in the architecture of the Economic and Monetary Union. Notably the complete absence of a crisis resolution mechanism which would allow to support euro area Member States in case of an acute financial crisis and equally fundamental: the crisis put the spotlight on the lack of effective economic and financial surveillance, in particular beyond the fiscal dimension.

The EU acted on all of these aspects. The EU put into place a financial support programme for Greece and Ireland. These programmes provided important breathing space for these countries to restore financial stability and confidence. The EU Financial Stability Mechanism and the European Financial Stability Facility were created as temporary facilities and work on the establishment of a permanent crisis resolution mechanism, the European Stability Mechanism is under way. Regarding economic coordination the Commission presented in autumn 2010 a comprehensive governance package with a view to strengthen fiscal discipline, but also to address other macroeconomic imbalances and competitiveness challenges more effectively in the future. Moreover, the economic surveillance cycle was changed fundamentally and modernised in order to give it more political traction and to allow for more integrated and more effective ex ante coordination across Member States. Guidance would be given at the beginning of the year in order to make sure that by the time budgets arrive at national parliaments the European dimension can be taken fully into account. Finally, there is a new Europe 2020 Strategy to set out clear priorities to address the boosting of potential growth and to provide a longer term vision for the modernisation of the EU which is utterly important to get out of such a deep depression.

What we need in Europe is deeper economic coordination. The shock of this crisis (Greece) really raised the awareness of all EU Member States of their interconnectedness in particular those inside the euro area. The key elements of the new Commission proposals go beyond the simple surveillance instruments and put in place the right analytical tools and rules to prevent market economic distortions early on and to ensure corrective actions where they occur. There will be a consistent monitoring of key indicators. Some of these indicators have found

their way into more recent proposals like those of Angela Merkel and Nicolas Sarkozy. (It is now important to bring these two tracks back together – as such it is a good thing that heads of state take responsibility – the eurogroup has been very much in the back seat for too long).

In future, where the Commission identifies risks, it will make country-specific recommendations on how to tackle these imbalances. In particularly serious cases the Commission and Council will step up surveillance to make sure that those countries take the appropriate actions. These action plans which Member States are being requested to draw up and to implement will have to be tailored to the specific needs of the countries. They include a pretty wide range of policy areas including fiscal and financial market regulations, labor markets etc., but it is also important that there are clear rules, that the institutions have the power to enforce them and that they really shape economic priority setting for a meaningful time. The Commission, therefore, proposes sanctions in case a Member State is not collaborating. The possibility to impose such sanctions is essential for the effectiveness of that new regime and for its credibility. The lesson from the Stability and Growth Pact (even though the sanctions foreseen were never applied) is that without sanctions you do not get political attention for the issues.

There is need for action on three fronts. First, there is the need for priority action on the policy front (Annual Growth Survey). The first priority is to restore confidence and to break the vicious circle of unsustainable debt, disruption of financial markets and low economic growth. This calls more generally for the rigorous implementation of fiscal consolidation and growth-enhancing reforms, the correction of market economic imbalances and the repair of the financial sector. Balance sheet repair in the bank sector is essential for removing the clouds of suspicion which still hangs over the European banking sector. Tougher stress tests are being planned for the summer. In order to really make an impact they must be combined with measures to recapitalize, restructure and dissolve banks where this should be necessary. Second, we need to make progress on the economic governance front with the implementation of the Commission proposals. The negotiations are in the hands of the Council. The European Parliament must draft its reports. Soon trilogue discussions (involving all three institutions) will start. There is reason to hope for political agreement in the summer. Thirdly, the establishment of a permanent European stability mechanism is needed. The European Council of March 24/25 is the next mile stone. On the 11 March there will be a summit with the heads of states of government of eurozone Member States. If we manage this agenda successfully, there is a legitimate reason to believe that Europe and the eurozone will emerge strengthened from this crisis

A less optimistic assessment of the measures the EU has been taking was that all these measures like rescue packages, European semester etc. are very useful, but some of these measures are not dealing with the fundamental problems of the current crisis. They will prevent the next crisis, but will not help to resolve the current crisis. If the current one is a debt crisis, we have an issue about how to reduce debt (increase) and we have to put Greece in a situation where it is able to grow again - on its own legs, not with support coming from other countries. How do you do this? Is Greece's current debt sustainable, can Greece really grow and pay back its debts? This is doubtful. We are worried about a situation where there is default. The current approach is that we provide some financing to the Greek government and the Greek government buys back its debt. Experience teaches us that this way you don't manage to reduce debt in a substantial way. Creditors can minimize their losses, but the debtor does not achieve to reduce debt significantly. If we assume buy back of debt realistic in a way that the creditors can minimize their losses, would this be what we wanted, assuming that what is left debt-wise is sustainable?

The European Stability Facility will not resolve the problem, because the debt of countries like Greece and Ireland are too high. Ireland simply cannot pay back. Either we will have to keep providing money or we find a more radical solution which will not be without pain. We have to decide that for the next decades we want to live in a situation of fear that every day something can happen to the financial markets or we want to solve the problem and go back to a certain normality in the eurozone so that we can grow, even if we will not be able to go back to the situation before the crisis.

What we have to avoid is that Spain as a big country will go down the same road. It is not clear whether we can deal with a crisis in Spain. It is clear that there are huge bobbles in the housing and credit sector and we do not know the size of the losses. Neither do we know what the situation is of banks in both countries. All the banks passed the stress test. But there are problems with this test which was considered an instrument to regain the confidence of the public. We have to impose tougher test, but what exactly does this mean.? If we want to fix the situation in the banking system we have to understand the situation in which it is.

### **A problem of confidence**

Galbraith once said that you should always distrust authorities when they're too optimistic, because if they say that we should be optimistic the question is why they are saying this and what their secret agenda is. From language you can always deduct a lot about how knowledge and power work ( Michel Foucault). The problem we have at the moment is a confidence problem. We believed that the euro is here to stay. We had one scenario. In such a situation you have confidence and trust. We all thought that the Euro was here to stay and now we started doubting . That is the main problem. The problem will be solved when we go back to the one scenario again.

If you have this in mind you can immediately see what problems you have to face. This crisis is very complex. There are different parties involved: politicians, citizens and investors. Normally they operate in different fields. But in this case everything is connected. The interdependency is very present. You could see it in the communication of the ECB and in Merkel and Sarkozy's press conferences. What the authorities try to do is to create commitment with all these parties involved.. The financial market is very new for politicians. It's a market, it has no face. It is very ambiguous . So, how to address the market? At the end of October Trichet and Sarkozy had a minor conflict during a meeting on who is going to pay for the stability. This seeped out. The thing was that they were both addressing different audiences. Trichet solved that very nicely. During a press conference he said it was never meant to be public and he refused to comment on or deny it. What does independency mean in such a crisis? You see that Trichet tells a different story. He is trying to engage politicians. What Merkel and Sarkozy did was very much a power play especially from a communication perspective. They immediately addressed their audience, the financial markets. By addressing the financial markets they put other politicians under pressure. Now the financial market has expectations and this can be used as a disciplinary new power play between politics and financial markets. The main point of this crisis is this new power play between politics and the financial markets and how to solve that.

### **The euro experiment**

To the question whether they would introduce the euro again with the current state of knowledge, the experts reacted differently. The most optimistic assessment was that the euro has been a blessing for the EU, certainly if we consider that we had to make all these adjustments with national currencies. It is true that it makes adjustments for the countries

which are hit hardest much more difficult in the short term. But you have to see that with the help of the EU programmes Greece in five years will look completely different than it looked in the past. The adjustments that are being made are also in the self-interest of the countries concerned. To see that the Danish government with view on the upcoming elections is considering a referendum on the euro is a sign of confidence. There is a basic consensus that the euro is here to stay. The break-up of the eurozone this is off the table: it would be disastrous.

But we have to have some sort of basis where we can address these policies. You have to have common rules and you have to make sure that there is even-handedness in how you design policy recommendations. This is the problem with the Paris-Berlin proposal which pursues an intergovernmental process: how will it be enforced and how will be guaranteed that the assessment being done is the same for all countries, big and small?

An even more optimistic reaction was that, even without fiscal union, the introduction of the euro was a good idea, because with huge projects you have to deal with political reality. A complete package with complete rules was not possible, it never is. Still, as a politician you have to go ahead. There is reason for optimism in respect of the euro: we are learning how the economy works and it will discipline us.

The most moderately optimistic answer was that for Europe the euro was one of the greatest achievements of the last ten years. Again, this is not a crisis of the euro, but a debt crisis. The current situation shows that there is one leg missing: we are a monetary union without a fiscal political union. Ten years ago we said we can make it. We still can, but we need to address the problem. We need to resolve the current crisis not the next one. The lesson is: one should be careful with a monetary union without fiscal political union.

On the other hand, European integration has always been ahead of realities. All big steps in Europe's integration were risky: the Schengen zone as much as the euro. As Spinelli once said: visionaries always have to be slightly ahead. (Though visionaries also should have back-up options as they are playing with the lives of people.)

In European economic history you had to have to have visionary decisions in order to move ahead and you need a degree of ignorance of details to make bold decisions. To these ideas belonged the single market and the introduction of the euro which we hoped would create changes in behaviour. There was the hope - which was disappointed- that there would be an understanding that in monetary union you do not have the nominal exchange rate devaluation as an easy way out in the short term if you have structural deficiencies in your economies. The crisis has written home very clearly that you can live for a long time with the illusion that house prices and wages can rise for ever, but eventually there is no work any more.

### **A cheap crisis for banks?**

Never in history there was a crisis where the banks came out so cheap. Why are we so concerned about the banks? The reason is that during the last years the financial sector has assumed very large importance in our economy. The second reason is that the financial system is highly integrated. If something is going wrong in one corner of the banking system, it has a very large effect on all of the eurozone and governments are very worried about the situation of their national banking systems. Everything could fall down. The banking system works a lot with the trust of people. If you lose this trust, everything goes down.. An economy for the next years without a functioning banking system is unthinkable. The shock

of the bankruptcy of Lehmann-Bothers sits very deeply. We still don't fully understand the interconnectedness of banks. Letting a bank down is just too risky. We are as persons much involved. When a bank or the financial sector gets into trouble, we as people get into trouble. It gets into people's lives. That is why we are so concerned. It has come as a surprise for a lot of people that they are so closely related to the welfare of banks.