

Policy Notes

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The 'Policy Notes' series is published as part of 'Europe's Strategy Towards New Forms of Global Economic Governance - Implications for Canada' -- a project supported by the European Commission's Public Diplomacy Program.

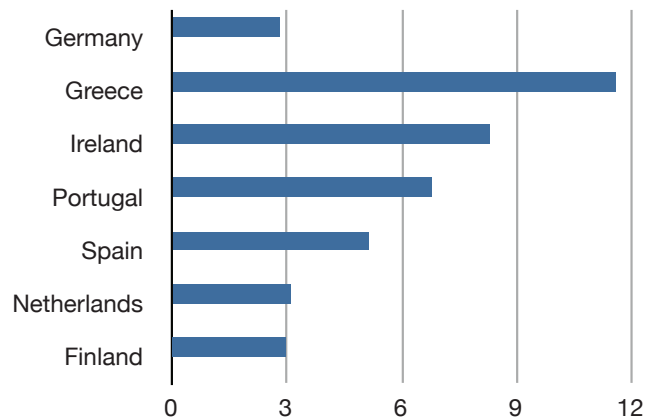
Stress Test and Political Cacophony

Prepare ourselves to think about the heretofore unthinkable: The break up of the Euro Zone. What started as a much-higher-than-expected debt-to-GDP-ratio in Greece, made its way to Ireland may soon arrive in Portugal and Spain. So far, these two southern core economies of the Euro Zone have avoided the regulations of bailout packages, which now seem to have merely been delayed. Already, the spread of Spanish and Portuguese government bonds compared to German Bunds has increased significantly. Yet, even Germany recently had to pay a small premium on its government bonds, as investors feared that the exposure of German financial institutions in the debt-troubled economies of the Zone might endanger economic stability in Germany—turning the crisis deadly for the Euro Zone. It is now well established that the common currency cannot survive with such huge differences in debt costs (table). Just how to overcome the crisis, however, is hotly contested.

Financial markets are instinct-driven beasts that smell blood where blood is spilled. The time is not for rational economic arguments. Pointing out that Spain has a lower debt-to-GDP ratio than Germany does little to make financial market actors rethink their actions. The current pressure on Spain is not solely

about Spain and its economic situation or about fears that the Spanish government may not be able to deal with the economic problems; it is about the stability and the future of the Euro itself. The piecemeal emergency measures of the last 12 months or so have successfully helped to overcome the liquidity crises on the European periphery. They are by far not sufficient, though, to deal with the fundamental problems of the common currency.

Financial markets are performing their own stress test. Unlike the virtual stress test of European banks from summer 2010, this real life procedure points to a political stress management failure at a magnitude that surpasses predictions by even most critical observers of the EU and the Euro Zone. Discussions over the last months have demonstrated that in times of crisis national governments strictly follow national interests. This reflex creates concerns among financial market actors about a clear-cut crisis strategy for the Euro Zone as a whole. So far, the EU Commission has not acted as a self-confident political player who will run the show; rather, its performance confirms the long-standing impression that it is a politically selected agency that does not stand up against the retreat into pure inter-governmentalism by European governments.



Interest Rates for Ten-Year Government Bonds
- 12 December 2010, Commerce Bank

The European Central Bank, despite its many successes since the outbreak of the financial and economic crisis of 2008, started its own decapitation when Alex Weber, German board member and potential successor of Jean-Claude Trichet, made public his opposing view on the purchase of troubled bank assets, thereby opposing the political strategy of his president. The standoff was complete when Italian board member Lorenzo Bini Smaghi, himself a contender, stepped in and supported Weber. Meanwhile, President Jean-Claude Trichet favors – as does the IMF under Frenchman Strauss-Kahn – the significant extension of the European Financial Stability Facility (EFSF); this has met strict resistance from German Chancellor Merkel. Opposing views are just as strong inside the member states— even inside coalition governments—as they are between member states. Cacophony reigns, in short. To be sure, the Euro crisis is as much a political crisis as it is an economic one.

LOOKING BACK

For much too long European politicians were not willing to admit that the Stability and Growth Pact (SGP) was a failure from the very beginning. Defining stability in the Maastricht criteria by numerical values and focusing solely on monetary and financial criteria made the SGP to a straitjacket that forced nationally-elected governments either to move into the business of creative accounting or to follow narrowly defined rules and thus to give up the freedom to use fiscal policy to create and design political projects. The brief history of the SGP shows that governments were not willing to accept and implement the restrictions of political sovereignty. When the rule-based policy approach of the SGP created problems for core economies like Germany and France, the governments of both economies used their veto power in the European Council to

avoid receiving the embarrassing ‘blue letters’—part of the so-called excessive deficit procedure. It was helpful for the two most powerful governments of the Zone that the European Commission was a weak institution that easily could be hijacked.

However, it needs to be stressed that the many violations of the SGP have very different causes. Slow growth and high unemployment, for example, was the root cause for Germany’s violation of the SGP, and not uncontrolled spending by the Red-Green coalition. Fiscally punishing slow growth with obligatory retrenchment actions seems not to be an adequate macroeconomic cure for such a situation. In the case of France, it was a combination of slow growth and overly high spending that led to the violation of the 3 per cent criteria. Again, getting the economy back on a growth path was the right thing to do, even if this increased public deficits. Greece was a case where government spending in combination with low tax receipts created fiscal havoc. The decisive underlying condition however was its worsening international competitiveness and thus the explosion in its current account deficit that made external credit funding necessary. Ireland moved its accumulation regime in best US-fashion onto a rapid path of financialization, only to end up with a serious banking crisis that undermined public budgets for quite some time. Portugal has a severe private debt problem in combination with a lack of international price competitiveness. Spain suffers from high private debts and an oversized real estate sector in combination with decreasing price competitiveness. In all these cases, the aftermath of the financial and economic crisis made violations of the SGP unavoidable. The emerging situation only underlines that the numerical strictures for accepted public debts were humbug from the outset.

The often-made argument that the politically enforced changes of the SGP in 2005

opened the gates for increasing public debts is not supported by empirical data. On the contrary, on average debt-to-GDP ratios shrank after 2005. It was only the financial and economic crisis that eventually led to a drastic increase of this critical indicator. Steep reductions of tax income and even steeper demands for public spending to avoid the meltdown of economies and deal with the social consequences of the crisis generated a scissor effect. A significant share of those additional state expenditures, lest we forget, went directly to the financial industry. Since then, we have seen the empirical confirmation of an historical truth: financial crises are followed by national sovereign debt crises. This time, it is in Europe and the Euro Zone where history confirms itself.

POLITICAL CACOPHONY REIGNS THE DAY

Rule-based responses are fashionable yet again. The proposal of the Van Rompuy Commission to strengthen the SGP by adding stronger punishments—very much supported by parallel suggestions of the German government to withdraw voting rights in the European Council for serial violators of the SGP—repeats the original sins. Making punishments a first order rule is no contribution to overcoming the crisis. Nor does forcing troubled governments to introduce drastic austerity programs in times of financial instability and low growth provide an adequate way out of the crisis. Ireland and Greece demonstrate that public deficit reductions made too abruptly and too harshly undermine economic growth, and make the situation even more unsustainable. Markets sense that Greece may never come into a situation to repay its debts, and that the same fate will hold for Ireland and probably for Portugal and Spain, as well.

Sooner or later, a haircut will be unavoidable. Governments are not willing and

maybe not ready to accept such an option, and thus it is up to financial markets to urge them to unveil potential political responses to the emerging situation. They also want to know, preferably earlier rather than later, what mechanisms will be put in place when the EFSF runs out in 2013. It speaks of the senseless naïveté of the European governments that they established this fund only for a short period of time. Proposals to substantially increase the funds, suggested by the likes as Strauss-Kahn, met strict opposition, particularly on the side of the German Chancellor who feared an upheaval in Germany, given that the German taxpayer would have to shoulder a vast part of such additional funds. This may be a political gesture towards the electorate, though, but gives further indication that national governments continue to play for their national audiences and not in order to find a sustainable way out of the crisis situation. The most recent decision at the December Summit in Brussels to make the EFSF a new institutional mechanism of the EU without increasing its funding seems to be once more a small step instead of the large leap the crisis is demanding.

The inability to read financial markets is the signature feature in the proposal favored by the German government to force holders of troubled government bonds to accept a haircut. In principle, such a measure can be justified and can be a smart mechanism to decrease the level of moral hazard on the side of financial markets, as investors always have to be aware of a risk element in their choices to invest. If I am right that economies like Greece and Ireland are already on a path of insolvency and that haircuts there are becoming unavoidable, the German proposal to include private creditors in any debt restructuring smells of realpolitik. However, any haircut strategy needs to be operated in an orderly manner, and this includes efforts and well-designed plans to provide troubled states with open

access to financial markets. Should haircuts be executed for old debts or are they meant for new credits? What is the ranking of new and old credits in this regard? How will national governments be provided with new debts if financial market actors respond to haircuts with credit rationing? In other words, to avoid an Argentine situation, debt restructuring needs clear-cut rules that provide transparency for all actors. So far, the German government has not devised a plan with the needed details. This lack of precision frightens financial markets, and contributes to the high level of edginess that already exists. The immediate response is a further increase of risk premiums and thus an aggravation of an already critical situation. Putting a proposal like this out in the public domain needs to be followed by swift action to surprise financial markets with *fait accompli*. One would have expected that the many episodes of recent financial crises would have taught politicians how to talk to financial markets - this expectation is never fails to be disappointed.

Preventing insolvency and sovereign debt default demands clear procedures and mechanisms to re-stabilize economies and place them back onto a growth trajectory without cutting them off from global capital markets. Recent financial history provides us with ample examples. Academics have the freedom to discuss those experiences in public. Governments, however, remain mum, at least insofar as they are not willing or able to immediately act on their what little they do say. Financial markets, like it or not, are high gasoline animals and respond to every rumor and half-cooked proposal. Merkel's strong argument in favor of haircuts played successfully with public opinion in Germany but simultaneously alerted financial markets that unforeseen costs may arise in the near future. This episode only confirmed the suspicion that national governments play along their national interests and more so along their electoral interests.

In this regard it was not really surprising how Merkel and Sarkozy brushed off the proposal Old Hand Juncker, head of state of Luxembourg (but in this case speaking as the head of EcoFin), to issue Euro Bonds in order to provide Euro Zone governments with a tool for refinancing debts. In economic terms, the suggestions to allow member economies of the Euro Zone to issue Euro Bonds of up to 40 % of GDP is sound economics, as it would be a incentive for discontinuing speculative attacks on selected members of the Zone. Germany and France immediately figured that such an instrument would shift debt burdens to their budgets because the service of those bonds would asymmetrically fall on the shoulders of the relatively strong economies. Given that, in case of sovereign debt defaults, strong economies already carry directly and indirectly the lion share of the adjustment burden, such an argument against the issuance of Euro Bonds is not very convincing, or reflects the dim hope of governments to avoid further defaults. The real issue seems to be that turning to Euro Bonds implies a drastic transfer of fiscal sovereignty to Brussels, as financial markets only will validate those bonds if they are covered by sound fiscal policies. In other words, Euro Bonds would mark a step towards a fiscal union – something at least the Germans want to avoid at any price, even at the price of a worsening stability crisis of the Euro Zone.

The parallel attempts to improve the SGP and to remove the crisis through fiscal discipline are already water under the bridge. Nevertheless, this stream of thought runs wildly in European government circles where the 'Schwaebische Hausfrau'-approach sits closer than any macroeconomic insights. Punishing violators and traitors is a deep-sitting motive but it is no good guidance for adequate political action. It goes without further saying that fiscal prudence is a necessary condition for financial stability – but it is by far not the only condition re-

quired. The situation forces us to realize that the Economic and Monetary Union needs Political Union to survive. Already, the Euro Zone is moving quickly into a transfer union where stronger members support weaker members. This transformation is happening stealthily and reflects political despair and not political self-confidence about the future of the Euro Zone. It is time to talk openly and in rational ways about this option. Creating a common fiscal space in Europe would come with the most fundamental transfer of sovereignty in recent EU history as it is the public budget that bundles and expresses preferences of national political majorities. Stated this way, it seems obvious why European governments, and even more so national electorates, are currently not willing to follow such a path. In such a situation, European governments opt for piecemeal engineering at the expense of punishment from financial markets that no longer support such a crisis mode.

European integration and monetary unification require a new foundation and new political proponents—current political leaders are sorely unfit for such a task.

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17 December 2010