Open letter to the European Council, 11-12 December 2008, Brussels

Dear Head of State/Government,

It is now clear that the financial crisis is severely hitting the real economy. Heads of state/government meeting for the European Council will therefore have to consider taking additional concrete steps to ease the extraordinary tensions in the European financial system and to counter the very sharp economic downturn.

Concerning the financial system, about two months ago a special meeting of the heads of state/government of the eurozone, involving also the UK Prime Minister, showed that *in extremis* member states can avoid divergent responses to the crisis. Member states agreed to a common approach (essentially recapitalization and guarantees for bank liabilities) with individual member state implementation. EU leaders chose not to organize the rescue effort in a single action conducted through a European institution. Two months later it is becoming apparent that mere coordination has its limitations.

When Europe's governments were facing the clear and present danger of a wholesale breakdown of the European banking system, common actions were seen as desirable not least because markets expected them. As the sense of immediate danger of a systemic collapse has waned, national actions are again drifting apart. Different countries emphasize different policies and implement them in quite different ways.

Immediate dangers arise from the fact that only a small fraction of the large sums announced initially have actually been committed. Close to 2 000 billion euros in public funds for support to the banking system had been promised in early October, but little (less than one tenth) has been disbursed so far. This could potentially create a situation where banks just receive enough funding to keep afloat, but continue to restrict lending to rebuild their balance sheets. This is exactly what should be avoided. The danger of a system-wide credit crunch in the euro area still exists.

In the medium term there is also a danger that the European banking system would again become segmented into national subsystems as the conditions vary from country to country, with different guarantee schemes in place and with governments in some cases now acting as major shareholders. The EU's Single Market is an achievement that needs to be defended from dismantlement in the current crisis. This in turn requires common rules.

Turning to the real economy, the rapid pace at which the crisis is moving calls upon the European leaders to make difficult decisions on how to deal with the sharp fall in economic activity. The fiscal stimulus package, proposed by the Commission at the end of November and formally endorsed by ECOFIN, could in principle constitute the cornerstone of Europe's coordination mechanism. Unfortunately, the official announcement of coordinated action does not seem to correspond to reality.

Some national governments argue that their own economic outlook is not critical enough to require a stimulus and contend that there would be time to undertake additional measures should the situation deteriorate next year. Other governments also seem to be unwilling to commit to the common action. In our view, the current situation is extraordinary and cannot be effectively tackled on an individual country-by-country basis. Even the strongest economies in Europe are going to feel the full force of the downturn, especially those that are – like Germany – relatively more dependent on exports for their business cycle. If all member states were to adopt a ‘wait and see’ attitude, the downturn would become much stronger everywhere.

Under ordinary circumstances, the case for fiscal policy coordination within the eurozone would not be very strong. But under the present special circumstances, the economic argument for joint action is compelling. Even though the euro area is not yet in a classic liquidity trap (when the zero bound on interest rates renders monetary policy ineffective), already interest rates are no longer the main factor affecting the availability of credit. This implies that the international spillovers from fiscal policy are going to be unambiguously positive and potentially quite large. If national policies fail to recognize these positive spillovers and eschew effective coordination and common action, the fall in growth may become dramatic.

Under these conditions, all EU institutions should enhance their efforts to meet the present challenges. In particular:

- The European Central Bank and the European Commission should monitor credit conditions and report to the European Council. If they detect signs of a systemic credit crunch, they should submit concrete proposals on how to effectively counter it. They should also elaborate a tighter common framework for interventions in the financial sector to avoid a rollback in the degree of integration reached over recent years.
- The Commission should continuously monitor the economic outlook for the EU as a whole and propose adjustments to the fiscal stimulus package as needed, including concrete indications on EU-wide measures that could be taken by member countries in parallel.

We believe that the current situation calls for unprecedented actions. Over the last 50 years, European countries have created a framework for working together on a range of policies. This framework should now be used to the greatest extent possible in both the economic and financial policy fields. This is not a normal cyclical downturn. It is imperative that coordinated action is taken that is commensurate with the magnitude of the risks. Such action would not constitute a precedent once normal times return, but joint action is needed now to prevent the European economy from spiralling downwards.

Daniel Gros, Director Centre for European Policy Studies
Hans Martens, Chief Executive, European Policy Centre
Gaëtane Ricard-Nihoul, Secretary General, Notre Europe
André Sapir, Senior Fellow, Bruegel, and Economics Professor, ULB