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The Demons Awake: The Euro Crisis and how to emerge from it.

Jean Pisani-Ferry

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Synthesis by Erwan Bertrand, trainee research assistant at Notre Europe*.*

Introduction

Jean Pisani-Ferry decided to write this book in the wake of a seminar in Freiburg, where he had been asked to expound his views on the sovereign debt crisis that is on everyone's lips since it unleashed its full force on the Old Continent. In a nutshell, what he was really being asked was: "*Was ist die wirkliche Frage?*" (What is the real question?).

The author realises that the issue goes way beyond a mere explanation of the technical solutions that have been or are about to be adopted. He writes: "*Behind the figures, the procedures and the mechanisms, there are the principles that are being increasingly called in to question: coexistence, solidarity and democracy*". Thus the question presupposes a broader definition of the issues and challenges connected with the crisis. The peripheral crisis has turned into an existential crisis. Pisani-Ferry argues that: "*The democratic debate on the responses to the crisis is a political necessity, and it has become crucial also from an economic and financial point of view".*

The author maps out the path that led to the adoption of the euro, he describes events over the past two years, and he explores the potential avenues for emerging from the crisis.

This synthesis aims to summarise the main ideas that the author expresses and the underlying theme holding the book together.[1]

Utopia at the Lowest Level: The Birth of the Euro

For almost 10 years, the euro had all the makings of a spectacular success. The undisputed proof of this was the discretion which became a mark of the single currency. No one spoke about the euro, and indeed that was the unavowed ambition of Europe's central bankers. As the current governor of the Bank of England put it: "*Our aim here at the Bank of England is to be boring*". Inflation was dominated and the exchange rate showed no sign of being highly volatile, which suited both the Germans and the French expectations.

Yet a trend towards divergence started to become perceptible in 2005, and foreign deficits between the northern and southern countries in the monetary union gave no indication of improving. The ECB, despite having identified the problem, did not have the necessary means or the legitimacy in its mandate to respond appropriately. It thus fell to the national governments to take the situation in hand. The countries

[1] *The views expressed in this work are not necessarily those of* Notre Europe*.*

in the euro area either refused to heed the European Commission's warnings, like Ireland; or else they did not see, or pretended not to see, the warning signals, like Spain; while Greece went as far as to cook the books and to rig its accounts.

Since 16 October 2009, when Greece first admitted resorting to "creative accountancy" , the euro has ceased being boring. The money market demons began to stir after slumbering for 10 long years. That was also the day when it became abundantly clear that the euro project was incomplete. Disputes broke out in broad daylight over the solutions required, and it was then that European summits began following on from one another at an unprecedented pace, but without that leading to any definitive solution being put forward.

Jean Pisani-Ferry endeavours to explain how it proved possible to set up an incomplete monetary union. Among other things, he refers to the view prevalent in the early 1990s, based on Robert Mundell's theory of "optimal monetary zones" and the famous "impossible trilemma"[2]. He goes on to explore the debates raging among economists over the best approach to adopt for a single currency. Some were in favour of a smaller but more consistent monetary union with fewer members – a school of thought christened the "economist" school, whose adepts argued that the euro could only be the end product of a preemptive drive for convergence. That was the vision embraced by the Germans. The other school of thought, known as the "monetarist" school[3], was in favour a launch including the highest possible number of members, and that was the school that eventually won the day. The author also highlights the reluctance of Europe's leaders to build a sound and complete environment for this new currency, with the result that to some extent it became an orphan, because no one wished to be responsible for its failure but, at the same time, no one was committed enough to endow it with the tools that it needed to succeed. Europe's leaders at the time were focusing more on domestic policies both in the run-up to, and immediately after, the year 2000.

Crises Heralded, Crises Unexpected

A number of countries lived in a bubble right up to 2007, but that bubble was rapidly burst by the start of the crisis in 2008. Whether the crisis was initially triggered by real estate madness or financial frenzy, it was undoubtedly connected with the euro, and in particular with the single interest rate in the euro zone. The author uses the example of Spain, although he urges the reader to make all due distinction between the different origins of the individual member countries' crises in what we commonly call today the "sovereign debt crisis".

Despite the fact that Spain had been even more virtuous than Germany in budget terms between 2000 and 2007, it was still hit full force by the negative repercussions of the sovereign debt crisis. Basically, we might say that an excessively low interest rate on the ECB's part led to the real credit rate being far too generous, which in turn sparked a cheap credit boom that found its corollary in the development of the real estate business. The ECB bases its key rate on the euro area as a whole and cannot therefore propose a "tailor-made" rate for each country. The Spanish Government could have intervened by putting the thumbscrews on access to credit, but there would have been a political price to pay for doing so. The euphoria did not last long, which only made the return to reality even tougher. So the country is now experiencing a major growth in the level of unemployment, dwindling tax revenues and a daunting challenge to recover its competitiveness. The European Commission was quite right to issue warnings, but the national governments refused to heed the criticism so timidly levelled by their peers in the Council.

In order to achieve the status of "European export champion", Germany "donned the garb of an enforced penitent" and had to rekey its position in the global division of labour, as Jean Pisani-Ferry puts it. The work force ended up accepting the stagnation of their purchasing power in order to avoid job losses. If we bear that in mind, we can more easily understand why public opinion across the Rhine finds it difficult to countenance subsidising the budget deficit holes dug by imprudent member states. And it also explains why Germany insisted on a "no-bailout" clause in the treaty.

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[2] *This discusses the impossibility of simultaneously having totally open capital markets, fixed exchange rates and an independent monetary policy. Only two of the three elements can be chosen because it is impossible to choose all three at once.*
[3] *Not to be confused with the traditional monetarist, led by Milton Friedman.*

At this juncture, the crisis highlights two further questions: the question of the aid plans' soundness, and that, in turn, begs the question: is affording assistance to a country in difficulty going to lead us *de facto* towards a "transfer Union"? After all, the taboo on providing assistance was lifted with the aid plan for Greece and with the establishment of a permanent rescue mechanism. Of course, that does not resolve the problem of imprudent creditors. Given that the banking sector is involved, Europe's leaders have sent out many ambiguous messages, and this has helped to increase the confusion on the money markets regarding the methods for emerging from the crisis.

What Is To Be Done?

The money markets have not proven to be the cold, calculating repositories of rationality as depicted in most economics manuals, a fact which is perfectly illustrated by the undershooting in which they have been indulging for years. Seeking ever higher returns, the money markets have systematically underestimated the risks linked to sovereign debts and they have been playing down the difference in the various euro area member states' solvency. Now they are engaged in a frantic search for security. From 1999 to 2008, the finance ministers got the impression that they had shaken off the constraints of the past, but in actual fact those constraints had simply acquired a different shape. The parenthesis closed again in 2010. The ratings issued by the oligopoly held by Standard & Poors, Moody's and Fitch may now frighten governments more than spreads[4]. At this juncture, the public debt bond market has become more complicated than it was before the crisis. Investors now take several scenarios into account, while the important thing before was primarily the liquidity ratio. The problem lies in the fact that ratings can accentuate cycles and trigger self-fulfilling prophesies, once the rating of a country's debt has been downgraded (to below "*investment grade*"). Moreover the role that the governments themselves have assigned to these ratings is an even greater cause for concern[5].

The banks had to be saved. Governments provided them with funds in 2008, while in 2011 it is the banks that have brought the governments to their knees. All of this arouses indignation, but as Pisani-Ferry tells us, "*indignation does not forge policies*" and we may learn some extremely practical operational lessons from it. So, what needs to be done to bring the indebtment rate down? Printing money can be ruled out due to the risk of inflation that it entails and to constraints in the ECB's mandate. Prompting households to buy into the debt also seems to be a non-starter because it would call into question both financial integration and the funding of business. But having said that, governments must consider the money markets as their partners and ensure that they are at their service. Consequently, the only choice possible is coherence. The money markets are forcing the leaders towards a single possible option: integration. They will have to "dance with the wolves".

Given the loss of the exchange rate devaluation tool, it is going to be necessary to resort to "internal devaluation". Everyone agrees that competitiveness has to be recovered, but achieving that by slashing prices and salaries is never an easy thing to enforce. Latvia is about to succeed in doing so without having had to cut its currency's links with the euro as the IMF had recommended it do. But on the other hand, such an exercise might prove more difficult for economies like, say, France's than for small, open economies. The Europeans are going to have to battle against the temptation to "dismantle" the euro area. The four obstacles in the way of a hypothetical "dismantling" are of a legal, technical, economic and financial nature, the latter two carrying greater weight than the former two. It is hard to envisage a country short on competitiveness managing to recover that quality solely through devaluation after leaving the euro area. To do that would be tantamount to its burying its head in the sand and denying that its basic problem is one of competitiveness and of credibility. The results are easy to predict: the impoverishment of households, major inflation and rising import costs. The risk of overadjustment is very real. The last obstacle would call financial integration into question, because the expectation of a country leaving the euro area might lead, among other things, to a massive withdrawal of household and business assets towards havens deemed to be safer. Naturally, no obstacle is insurmountable, but who would be prepared to shoulder the

[4] *In other words, the differences in long-term interest rates among the various EU member states.*
[5] *For instance, the range of bonds eligible for refinancing the ECB depends on their rating.*

responsibility for such a high financial and social cost? Not only would the country fall prey to social and economic chaos, but the risk of contagion would increase once the exit option had been aired.

The crisis has highlighted two major fragilities: there is the fragility of banks and governments, and they are all the more fragile for being interlinked. The second fragility concerns the impossibility for the ECB to use the "bazooka" about which there has been so much talk recently. The author concludes that the time for pragmatism is over and that the euro area needs more means and direction if it is to win back its credibility.

Specific Guidelines for Resolving the Crisis of Confidence

Eventually, Pisani-Ferry takes a look at the options that might resolve the confidence crisis. He argues that the Europeans are facing three distinct problems. The first problem can be summed up in the following question: on what principles should we base our search for a solution to the sovereign debt crisis? In principle there are three types of answers to that question that should be worth considering. The solution might entail a diet of states budgets; banking federalism involving a common rescue plan for banks and federal supervision; and the creation of a common debt agency issuing debt bonds with common guarantees. The last type of response brings us automatically to the second problem, which concerns the political organisation of the euro area. It is difficult to envisage joint guarantees without assessing institutional and political implications. The author specifies that the time for bolstering an oversight system that kicks in after the event is over; what is needed today is to set up *ex ante* surveillance mechanisms. That might consist of a European right of scrutiny and of veto regarding the budgetary decisions of member states in the euro area. Naturally, such a right could only relate to the ceilings of budgets approved by national parliaments, without going into the substance of the financial laws themselves. He adds that the entity called upon to judge national budgets must enjoy strong legitimacy in the eyes of the European citizen, in accordance with the well-known principle of "*no taxation without representation*". The third problem involves putting the southern countries back on track. The challenge lies in avoiding stagnation and prolonged underemployment. The author suggests a range of measures which might be taken into consideration to address the challenge of a return to competitiveness. The countries involved have several options open to them, ranging from fiscal policies to a return to industrial policies. Like Germany, each one must redefine its place in the European and global production chain, but Europe, for its part, will also be a stakeholder in these decisions in view of the role that it plays in establishing the overall framework for economic policies.

Conclusion

Jean Pisani-Ferry's book provides a clear answer to the question he was asked in Freiburg, allowing the reader to gain a better grasp of the links between all of these different crises that have amalgamated to form a single, massive European sovereign debt crisis. The book highlights the causes and issues involved, but formulating a response is, of course, an altogether more difficult exercise. Yet the author still offers the basic elements for a response, while repeatedly pointing out at the role that the European institutions can play in restoring credibility. Europe has no choice but to evince greater consistency if it wants to prevent one of its greatest projects, the euro, from being called into question again.

Jean Pisani-Ferry has been the director of the Bruegel think-tank since January 2005. He also lectures in economics at the University of Paris-Dauphine.

He is a member of the executive board of Notre Europe.