Franco-German workshop series on the Euro area

Summary of the debates

The crisis of the Euro area is not a simple consequence of the global financial crisis and the resulting increase in national debt. It finds its root in the Treaty itself, which prohibits the bailing out of a Member State by its partners and the monetization of the debt by the Central Bank, without considering the logical consequence of these two prohibitions: the default of a member state. This danger was supposed to be reduced by fiscal rules as laid down in the Stability and Growth Pact and by market discipline. This approach neglected powerful factors, the combination of which resulted in the current crisis: (i) the capacity of the governments to dissimulate the real situation of their public finances, (ii) the huge off-balance sheet risk that resulted from too-big-to-fail banking groups, and (iii) the impact of the accumulation of external liabilities which resulted from negative real interest rates in the most inflationary countries of the Eurozone, given the perceived absence of exchange rate or default risk and of discrimination in European Central Bank's collateral policy.

The answers to the current crisis had to be found in urgency and without an explicit long-term perspective. The European Council of December 9 th 2011 marked a turning point, with a frank discussion on the political organization of the zone, the role of the European institutions and the need to endow them with new competencies. The Fiscal Pact based on an Intergovernmental treaty is considered a step towards the new governance structures of the Euro area. But further steps both in crisis management and in governance reform will have to be taken.

Different conceptions in particular between Germany and France are likely to surface in this course of action. While the December 9th summit expressed some agreement on fiscal discipline, other disagreements remain, in particular on growth policies in Europe, banking regulation, debt pooling not to mention fiscal and political integration.

Taking into account the renewed leadership of the Franco-German couple in the crisis resolution process and the deepening of the European Monetary Union, SWP, CEPII, Centre d'Analyse Stratégique and the Club du CEPII have decided to launch a series of workshops bringing together economists and political scientists of both countries in Berlin and Paris to tackle these very important issues. Two half-day meetings were organized during the first half of 2012, under Chatham House rule: one in Paris on March 21st, 2012 and one in Berlin on 14th, June 2012.

Paris, 21st March 2012: Fiscal rules in Europe: anchor or straitjacket?

This first workshop was devoted to fiscal adjustment and rules and their implications for growth. The recently decided fiscal compact was generally welcomed by both German and French participants. In particular, it was stressed that national rules would strengthen ownership of fiscal efforts. However, the participants disagreed on several important points:

- The impact of fiscal adjustment on growth: while some participants stressed the positive effect of a more credible fiscal policy and the existence of "low-hanging fruits" (like the improvement of tax collection) in some peripheral countries, others insisted on the negative, Keynesian impact of fiscal contractions and the subsequent self-defeating risk of such contractions. Additionally, national fiscal rules were viewed as a way to foster national ownership of fiscal discipline, in the absence of strong appetite for fiscal centralization.

- The need to differentiate the pace of fiscal adjustment across Euro area countries. While some participants suggested not to adjust too fast in those countries (like Germany) that still retain some room for maneuver, others stressed the needs to preserve the credibility of Germany which is not the only anchor in the Euro area. Similarly, there was no agreement on whether Spain should be given more time to carry out its needed fiscal adjustment on the ground that its banking sector needs first to deleverage on a large scale and that it is risky to carry out private and public deleveraging simultaneously.

- The needs to allow for automatic stabilizers to avoid pro-cyclicality. One participant asked why the Europeans had imposed tougher adjustments than those required by the SGP that focuses on cyclically-adjusted rather than headline adjustments. Another one suggested imposing obligations in terms of means rather than of results (e.g. amounts of spending cuts rather than deficit-to-GDP targets). One participant expressed some concern that too much fiscal restriction could in fact crowd out structural reforms. There was also a concern that hasty adjustment could happen at the expense of the quality of the adjustment.

- The effectiveness of the Stability and Growth Pact: one participant fiercely criticized the pact as ineffective and ill-profiled since fiscal sustainability is a long-run rather than year-by-year concept. In his view, the Europeans had better design a scheme that ensures long-run sustainability while offering short-run flexibility (possibly with the help of independent fiscal councils or Swiss-style debt brakes).

There was a deep exchange of views on sovereign default. While some participants expressed the view that the credibility of the no-bail out clause should be restored through recognizing the possibility of defaults, others argued that the Greek PSI proved highly disruptive. One participant said that triggering CDS contracts was useful since avoiding such event would kill the CDS markets, which in turn would reduce the demand for sovereign bonds. Another one noted that the possibility of further sovereign defaults would require the settlement of a banking union (deposit insurance and bank restructuring fund) in order to tackle the disruptive impact of such defaults on the banking sector.

There was some discussion on the newly-revamped fiscal and economic surveillance framework (Six-Pack). While everybody seemed satisfied with the new decision-making mechanism and the broadening of fiscal surveillance to macroeconomic imbalances, some participants did express concern on the pilling-up of technocratic procedures and the lack of national ownership.

On European initiatives in favor of growth, there was some skepticism about the use of the funds, especially when relative prices (between traded and non-traded goods sectors) are still distorted in peripheral countries.

Finally, there was a consensus that successful external adjustment would be key in achieving fiscal adjustment, although the way to do so was subject to debate, some suggesting that Germany could accept more inflation whereas others were favoring adjustment of relative prices through lower internal demand in peripheral countries and accelerated shift of resources towards tradable goods sectors (for which a further drop in housing prices would be good news).

<u>Berlin, 14th June, 2012: Changing the rules of the game</u>

This second workshop focused on longer term issues related to the growth prospect (session 1) and the governance (session 2) of the Eurozone.

<u>First session: "Growth strategies in Europe"</u>

The positive contribution to growth and employment of pro-market reforms was not challenged at the micro level and, according to one participant, evidence of this is well documented in the case of France in the past 30 years. However, the aggregate benefit of these reforms was more debated, with estimates ranging from 0.5 to 1 percentage point increase of the annual growth rate in the best-case scenario. One participant insisted that the removal of anti-competitive regulations in the non-tradable sector would not only be helpful in terms of growth but it would also participate in the highly needed real price adjustment in the countries that have competitiveness problems. Another one stressed the positive impact of structural reforms on private capital inflows.

The absence of a clear conclusion on the aggregate benefit of structural reforms made it difficult to reach a consensus on the role that the latter shall play in the solving of the Euro crisis. Most participants deemed that their impact is limited in the short term and therefore that they need to be complemented. For example, the costs of the housing bust for the financial system in Spain is in the magnitude of 20% of its GDP, that is much more than structural reforms can offset. However, some participants again highlighted the necessity not only to boost growth but also to rebalance it towards tradable goods sectors, to which the collapse of the construction sector would contribute substantially. Additionally, one participant argued that the impact of structural reforms would not only be direct but also indirect, through a positive confidence shock, the latter occurring much earlier than the former.

On the downside of the debate, one participant insisted that the resilience of the German model to shocks, through adjusting wages and working time rather than jobs, still needs to be time tested. Others said that Germany has its own structural weaknesses such as in terms of general education (modest PISA scores).

How to complement structural reforms to enhance growth prospects in the short run? Several participants stressed the importance of maintaining the ability of the financial sector to lend to entrepreneurs, especially when a large reallocation of capital and labor is required (from the non-tradable to the tradable sector). Along the same line, it was suggested to reduce those regulations that impede labor mobility within each country and across member states.

On current account imbalances, one study showing that a wage acceleration in Germany would certainly "correct" the German surplus was mentioned. Unfortunately, the impact on the CA balance of other Euro area members would be limited, while Germany would lose price competitiveness vis-à-vis countries outside the euro area as well.

There was also a debate on existing or possible new financial instruments at the EU level. The potential of existing tools seems limited since they were not designed with this purpose in mind (e.g. Structural funds are oriented towards infrastructures whereas investment is needed in the tradable sector, the seniority of EIB loans is a hurdle). One participant rejected any form of debt pooling or new financing instrument at the EU level. Another viewed some sort of transfer as inevitable, since clustering of manufacturing activities was fostered by the introduction of the Euro and lead to increased income and wealth imbalances which, in a single currency area, need to be compensated through transfers.

<u>Second session: "Institutional reforms"</u>

This session began with a discussion on the German state of thinking in the run-up of the EU Summit (June 28 and 29, 2012). One participant insisted that what Germany wants is more rather than less European integration, eventually leading to a fiscal and political union. This should start by more ambitious and more concrete cooperation on economic policies, including labor market policies. On banks, it was said that the Germans would favor an initiative that would break the link between banks and national authorities. This could be achieved through transferring banking supervision to the EU or Euro area level. Next, any form of banking union would need to be financed by the banking sector itself, possibly with the European Stability Mechanisms (ESM) as a backstop. Such reshuffling will take time. While the German government probably does not have a masterplan for fiscal union, it still has insisted since 2010 that long-term issues rather than short-term fixes should be given priority in European discussions. However, Franco-German initiatives yet still remain to be elaborated, in particular because the debate in France is still lagging behind. In the absence of unanimity, further integration could be carried out by an "avant-garde", be it the Euro area, an ad hoc enhanced cooperation or just an inter-governmental agreement. One difficulty in the area of political integration is the French background of the referendum on the Constitutional treaty, where the French voted "no". This experience tends to mute any ambitious initiative by French politicians in the area of further integration.

The participants also discussed extensively the German Constitutional Court stance. The Karlsruhe Court is probably more flexible and evolutive than it is often believed. In fact, political debates are often framed in legal terms in Germany, hence the central role given to the Constitutional Court. It remains that the Court is very powerful and could, for instance, lead to postponing the launch of the ESM, although the mechanism itself in principle complies with the German Fundamental Law. A fiscal union would require not only a change in the treaty (Art. 125), but also a change in the Fundamental Law, that would need to be approved by a referendum – with a very uncertain outcome at this juncture. Conversely, new competencies (such as bank supervision) could be transferred to the European level within the present constitution, whereas in a country like the United Kingdom, a referendum would be needed.

Beyond this debate, Europe appears to experience a deep political crisis as illustrated by the opposition between the center and the periphery, the partisan resistance to austerity that takes the form of hostility towards Europe. This political crisis is probably aggravated by the absence of a wider discussion on what a political union could be and the way it could remedy to the lack of political legitimacy or the dysfunctions of the present European institutions. Indeed, we are facing the problem of the crisis being handled by Heads of States and Governments who were not elected for that purpose. Moving forward, there will be a rising contradiction between the will to transfer new responsibilities to the European level and the reluctance to increase the EU budget.

Financial markets, for their part, have become more prudent and increasingly skeptical about developments in the EU. Summits are no longer market movers and the focus is now on the longer term, with markets assessing the actual level of change and the impact of structural reforms in crisis countries and expecting more ambitious decisions. However, such long-term analysis is blurred by liquidity factors; hence the lack of transmission from reforms to spreads.

Moving forward, using the ESM to recapitalize banks directly would likely be a game changer. Conversely, a redemption fund would unlikely solve the sovereign debt crisis in the short run. Finally, markets still consider the ECB's Security Market Program (SMP) as the key of Euro area integrity in the weeks to come.