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The Sovereign Debt Crisis and the Future of the Euro

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July 2010

Centre des Études économiques

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ISBN: 978-2-86592-823-1
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Executive Summary

The specter of sovereign defaults is back. The roots of a sovereign debt crisis are deep and concern all the industrialized countries. In 2010, those fears coagulated on Greece because Greece was the worst offender. Disgusted by the political economy of the Eurozone, investors concluded in the spring that the Eurozone and its currency had lost its attractiveness. But it would be completely premature to conclude that the Eurozone is condemned. What happened in the spring is breathtaking and very much in line with the European tradition to use every crisis as an opportunity: the paper offers a dissenting, unfashionable and optimistic view of the future of the Euro.

This crisis forced European governments to recognize the flaws in the design of the monetary union and they responded accordingly. In the short term, fiscal tightening in the Eurozone will not break growth down but restore fiscal credibility. An appropriate exchange rate for the Euro will boost activity as it is already visible. Fears of a Greek default are disproportionate. A default would not be in the interests of Greece, the Eurozone, and other OECD countries; there are huge incentives to find alternative solutions. In the medium term, the survival of the Euro is, contrary to a recent common wisdom, not a question: the debate on fiscal federalism has already taken place twenty years ago and its conclusion was pragmatic. The pressing reasons which pushed back all the principled objections to the creation of the common currency are exactly the same today.

The main result of the crisis has been to give a clear mandate to the European leaders to correct the flaws of this governance and major steps have already been made and will be completed in the coming months. The political difficulties which were witnessed in the spring in designing this new framework should certainly not be minimized, and they are not definitely overcome. However, they have clearly been exaggerated, probably in part due to a deadly mismanagement of communication by European authorities.

Anyway, the results are here and they open much brighter perspectives than before. Budgetary and monetary policies as well as the exchange rate are on a solid footing. The results of the stress tests applied to 91 European banks provide yet another contribution to the restoration of confidence. Nearly everyone praised the transparency under which the exercise was led, in particular in Spain, due to the publication of detailed sovereign debt exposure. There was also sort of a good news in the relatively low level of capital shortfalls.

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Significant challenges are still looming. But do not underestimate the reality of a new political economy in the Eurozone: a new policy framework, the implementation of stricter fiscal stability rules under market scrutiny, crisis prevention and management mechanisms already exemplified by the European Financial Stability Facility are huge progresses made in the right direction. It is no surprise in this context that risk aversion is declining and that investors are back. “Invest in the Eurozone”? Now could prove to be good timing, don’t miss it.

July 28th, 2010

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Introduction

The Greek public finances debacle, initiated in December 2009, quickly turned into a broader European sovereign debt crisis. In America and in Asia, it has become fashionable to look with suspicion at Europe. European economic governance proved deeply flawed, can it be corrected? Is the very existence of the Eurozone undermined? Is this finally proof of the decline of Europe in the XXIst century world economy? These are questions which have been most frequently debated in the recent months. Investors seem to have made their minds: without clear economic, political and institutional answers from European authorities and while facing policy inconsistencies between the leaders of the major countries, the majority conclude that the Eurozone and its currency have lost their attractiveness. A few weeks ago in the Financial Times, Wolfgang Munchau went as far as predicting that the Eurozone would not survive the decade… adding that this comment still made him the most optimistic in town! This conclusion is, in my view, clearly premature, there are good reasons to think that Europe will find enough creativity and resources to get out of this disastrous 2010 spring semester. This paper offers a dissenting, unfashionable and optimistic view of the Euro. Its most important message is that it is sensible to act accordingly.

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The Roots of the Sovereign Debt Crisis

This time, emerging market economies are not the epicenter of the financial crisis. Having entered the crisis with a relatively strong fiscal position, they emerge from it relatively unscathed. Hence, their aggregate public debt ratio, at around 35% of GDP at the end of 2009, remains low compared with that of the advanced economies and seems unlikely to rise sharply. By contrast, the combination of large-scale fiscal stimulus plans, financial rescue packages and falling tax revenues has led to historically large government budget deficits and record levels of actual and projected public debt in most industrial countries. The aggregate public debt of the advanced economies is projected by the BIS to rise from 76% of GDP in 2007 to more than 100% in 2011 – a record high in recent decades. Moreover, the full cost of cleaning up the balance sheets of financial institutions – particularly against the backdrop of their continued high vulnerability to adverse shocks – is not yet known. And beyond 2011, many industrial countries face the large, rising pension and health costs associated with their ageing populations.

Following the quasi-collapse and public rescue of the private financial sphere and given this extraordinary convergence of factors, the sustainability of fiscal policy could only turn out to be a major financial concern. Public debt/GDP ratios are rapidly increasing in every industrial country, this increase being particularly high for countries particularly hard hit by the financial crisis. According to the most recent BIS data, the debt/GDP ratio is expected to rise between 2007 and 2011 by one third for Germany (reaching 84% in 2011), by less than half for France (99%), by more than half in the United States (95%), by four fifths in Spain (only 78%) and to almost double in the United Kingdom (99%) and triple in Ireland (91%). These levels, except for in Germany, Spain and a few others, are extremely close but what is even more striking is the size of the deterioration. The cumulative public deficit between 2007 and 2011 is less than 30% for all Eurozone countries, except Greece, but above 40% for the US, the UK, Ireland; the rescue of the private financial sphere in the winter 2008-09 in those three countries clearly remains a prominent – and durable – factor in the damage caused to public finance.

Sovereign risk concerns first arose following the large financial rescue packages and substantial fiscal stimulus programs announced in late 2008 and early 2009. Those worries then remained relatively subdued for much of 2009, overshadowed by concerns about the

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slowdown in global economic activity and the associated rise in unemployment. Nonetheless, warnings about fiscal responsibility began to appear in the spring of 2009, the most significant being the Chinese call addressed to American authorities to wisely manage their finance and their currency. At the same time, ratings agencies started publishing more negative ratings for Ireland, Greece, Spain, Portugal and the UK. Bond yields and credit default swap (CDS) spreads on the government debt of several countries also started to rise in 2009; sovereign CDS spreads on Dubai rose sharply after Dubai World unexpectedly announced that it was seeking a moratorium on its debt payments. Henceforward, the specter of sovereign default reappeared. It first coagulated on Greece because Greece was clearly the worst offender.

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A Greek Debacle, a Eurozone Chaos

Greek sovereign bond yields and CDS spreads started to drift upwards in December 2009 and then exploded at the end of April 2010, when Standard & Poor's downgraded Greek debt to "junk" status. Greece, with its bond yields spiraling upwards, had to ask for external financial help to continue refinancing its debt. A combination of factors – very weak growth prospects, high unemployment rates, a constant erosion of international competitiveness and the lack of fiscal transparency – had led to a continued weakening of investors' confidence in the government's creditworthiness. The more we learned about Greece, the more Greece appeared as a dramatic but trivial story, the $(n+1)^{th}$ country trapped in a debt crisis caused by its own errors. In short, in January 2010, Greece was simply a quintessential "IMF-case": let the IMF people camp at the Treasury, determine the conditionalities, design the usual austerity measures and bring an appropriate financing. Greece, 2,5% of the European GDP, should never have derailed the whole outlook of European finance.

The erosion of confidence accelerated and spread when it became unambiguously visible that other European countries were so acrimoniously struggling under the conditions and the extent and even the idea of a financial support. In early May, Euro area member countries and the IMF undertook to provide a joint €110 billion emergency loan package for Greece after its government pledged to implement severe austerity measures. Within days of the announcement, however, it became clear that this was not sufficient to calm investors' nerves. Within the same week, a rating agency lowered its ratings of Portugal and Spain, triggering sharp increases in their CDS spreads as well. In response to soaring bond and CDS spreads, EU and IMF policymakers announced a €750 billion joint fiscal stabilization package. In the wake of this announcement, sovereign bond and CDS spreads declined substantially from the highs they had reached during the previous weeks.

Sovereign CDS spreads for Japan, the United Kingdom and the United States also increased but, despite their comparable fiscal positions, they increased much less than those for the fragile Euro area countries. Two reasons illuminate this distinction. First, investors apparently considered the European austerity measures with mixed feelings. Including public sector wage cuts, tax hikes and increases in the retirement age, austerity was alternatively seen as promised to fail due to social unrest or, would it finally be enacted, to open a long but inevitable period of sluggish growth. Second, and much more

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significantly because this argument runs only one way, investors became absolutely disgusted by the political economy of the Eurozone.

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Flaws in the Design of the Monetary Union

Facing the need to act to rescue Greece, European leaders have been brutally confronted by the design flaws of the governing rules of the Eurozone. What has been made public in this turbulent period is that the original system of governance was intellectually and politically schizophrenic: on the one hand, the single currency represented an unprecedented degree of international integration, on the other it relied on national economic sovereignty. The present European crisis is a direct result of a governance structure that was exaggeratedly respectful of national sovereignty. The insistence that Greece's financial problems were "a matter of Greece only" was the best example of schizophrenia in action. There was a direct and explicit European interest in not letting Greece default and this transformed the Greek problem into a pressing matter for its fellow members. Investors were seized by the threat of the Eurozone disintegrating.

An ancient and honorable tradition of the European Union is to turn every crisis into an opportunity. "Eurosclerosis" in the '80s was the precursor of the Single Act of 1986; the crisis of the Exchange Rate Mechanism in the early 90's accelerated the creation of the single currency. Now, following Rahm Emmanuel's suggestion that you should "never waste a good crisis", there are good reasons to believe that the crisis of European economic governance which has been so brutally highlighted in the spring will follow this traditional pattern if only because alternatives are so unattractive. Never forget the deep economic rationale of the single currency which can easily been underestimated if you don't pay sufficient attention to the reality of the biggest domestic market in the world: without the Euro, the European economy, businesses, jobs, savings, assets, everything would simply be in jeopardy. The absence of the Euro would have imposed huge costs to businesses and governments. Weak nations would have been confronted with balance of payments problems and would have been obliged to adopt restrictive policies; strong economies would have paid the price of their ~~very~~ successes. Germany as for one would have been confronted with declining European markets and with a much stronger currency; its powerful industrial machine would have suffered from languishing markets, unemployment would be higher, tax revenues lower, Germany's successes strictly depend from the common currency. Refer to the situation of Vermont, Michigan, Illinois, California and others without the US common currency and the conclusion is straightforward: the benefits of the

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Euro are as strong today as they were when the member countries embarked on this trip. The cost for every single country to "opt out" is huge; the academic argument in its favor, brilliantly offered by Martin Feldstein in the midst of the crisis, will not ignite any political traction.

Facing a financial abyss the size of the one already met after the Lehman Brothers' collapse, European governments had to recognize and overcome the failure of existing institutions and arrangements. High voltage meetings between the European finance ministers during two decisive week-ends in May and June turned out to be cathartic, the turning point in a Greek tragedy. The creation of the European Financial Stability Facility will be recognized in the future as a critical moment in the transit from crisis to opportunity. It is clear proof of the seriousness with which the leaders are willing to adapt, improve or renew existing rules. The most important lesson of those decisions is that leaders are willing to have a second look at the principles of the way the Euro is run. National positions have greatly shifted during the spring and I reject the idea, popular with many commentators, that agreement is impossible between nordic and well-managed countries on the one side and southern "club-med" countries on the other. With this vision of Europe, we would still be in a world without the Rome and Maastricht treaties, a world without a single European market and without a common currency: this is simply not the real world! Governance of the Eurozone is clearly a work in progress, and many important questions remain regarding its future. I will come back to this issue later; but before discussing complex medium term issues, let us turn to a short term, pressing one: the threat of austerity dealing a last blow to an already languishing recovery in Europe.

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Fiscal Tightening, Economic Credibility

Which came first? Private retrenchments or fiscal deficits? The answer is: the former. Everywhere, the collapse of private demand following the collapse of financial markets and institutions caused huge fiscal deficits. Now, the question is: how quickly should they be eliminated? The prescription is intellectually simple: avoid cutting fiscal and monetary stimulus prematurely (this is what we learn from the "1937 mistake"), and plan to reduce debt as soon as is feasible. How is this trade-off managed?

Europe is precisely articulating a pledge to bring – without precipitation – public finances back onto a sustainable path; this is exactly the right thing to do. Market pressure was so big that it precipitated retrenchment but retrenchment was in the cards. To be sure, a fiscal shock is applied to the peripheral countries of Europe, Greece, Ireland, Spain and Portugal; but it is plainly wrong to see these policies as heralding what happens in the rest of the Eurozone. These four countries account for only around 15% of the GDP of the Eurozone and the aggregate impact of their strong fiscal tightening will not be dramatic for the others.

More significantly, in effect, major Euro-economies are not embarking on drastic austerity measures. Despite all the fuss about fiscal virtue, Germany is maintaining an expansionary policy in 2010 (-0,5% of GDP), the tightening for 2011 and 2012 is – according to the German Minister Schaüble himself – more than modest (+0.44 and +0.19% respectively). This means that in the years 2010-2011-2012 the German planned tightening is limited to… 0.13% of GDP. France will have to do more, because its credibility is lower, but there is little danger of seeing French authorities err on the side of excess austerity. Generally speaking, the fear of an "overkill" fiscal reaction has been greatly exaggerated.

Some, the European Commissioner Olli Rehn for example, have pushed the argument further and introduced the idea of "fiscal expansionary contraction". The experiences of Canada and Sweden in the '90s, which are frequently used as examples of such a strategy, should be cautiously interpreted in the present context: Europe as a whole is not a small country and the world economy is not booming. But there is something significant in this comparison. With the ECB convinced that fiscal soundness is under way, interest rates are likely to be kept at record lows for a while. Briefly said, confidence matters.

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This is what Jean Claude Trichet rightly explained in the European Parliament: “a budget policy which from a certain point of view you might describe as restrictive is in fact a policy which we would call confidence building”. After months of confidence erosion, nobody can deny that this was the first parameter to be re-established. Early July in effect saw the first fruits of the strategy. Financial markets progressively reopened as exemplified by the success of a surprise Spanish offering in early July; at the end of the month, financial markets shrugged off setbacks in Hungary and Ireland which two months earlier would have immediately created severe strain; the mood is changing and confidence is increasing. The Eurozone bond crisis could have past its worst: should we assume so?

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An Appropriate Exchange Rate

Remember July 2008? This was the time of an (almost) almighty Euro which bought as much as 1,6 Dollar. Muddling through the financial crisis, falling by 18% since January 2010, the Euro has lost much of its glamour. Many see the recent decline as a severe blow to the single currency and we should only expect more of the same. In June 2010, most analysts thought that the decline had still some way to go, many were talking of parity between the two currencies, a few even began exploring the worst scenario: what about 1 Euro buying only 0.88Dollar as we experimented a decade ago? Things are not turning that way for understandable reasons.

Exchange markets are a good place to refer to the theory of "multiple equilibria". Expectations, much more than fundamentals, are key to explain exchange rates and volatility is the name of the game. Volatility between the Dollar and the Euro has continuously increased since the end of the gold-exchange standard in 1971, the two currencies have regularly explored new highs and lows: pause a moment to think that the dollar depreciated against the euro by 50% in less than a decade, what a (potential) loss for assets invested in dollars! Could the converse occur and, if yes, under which circumstances? If you make the case that the political economy of the Eurozone will remain what it proved to be this semester, you're right to explore unchartered seas where the Euro could sink to ever lower levels.

This said, given what we now know and following the interpretation we have just proposed, such a scenario does not make sense. First, the Euro did not sink. For all the clamor about the euro's decline, we have already witnessed periods of similar turmoil. And you always come to re-discover that the adjustments taking place in a market economy are not continuously cumulative but that price movements have powerful counter-balancing effects. Now, recall the fact that at approximately 1 for 1,20, exchange markets offer a more level playing field than at the beginning of the year. Expect now the benefits delivered by an appropriate exchange rate. European exportters have seen the overvalued Euro as a cross to bear! Louis Gallois, as for one, CEO of EADS, frequently denounced its devastating effect on Airbus sales and profitability and more generally warned of a dramatic decline of European manufacturing industry. At present levels, exporters are back, big manufacturers from Germany and elsewhere, medium sized companies from Italy, luxury goods producers from France and tourism everywhere, especially in the south.

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Cautious observers will naturally add some qualifications. The decline of the Euro will increase commodities prices; being unexpected, it will prove an embarrassment for those companies which had significantly hedged their businesses. Some, fearing uncertainty, will prefer to increase margins than extend market shares. All this is true but comes down to a basic principle of international economics: a reasonable value of the Euro will more than offset the presently estimated impact on growth of fiscal tightening and will also push back deflationary threats.

When Greece entered its crisis mode, in January, a frequent lamentation was that the Greek economy was definitely condemned due to its inability to devalue its currency. Well, four months later, the whole Eurozone enjoys a comeback of its currency to a level which is usually considered to be in line with purchasing power value. By the way, the Euro as a reserve currency has not been affected: according to the latest IMF data (2010 first quarter), the Dollar share of central banks reserves has retreated from 62,2 to 61,5% (a reduction which benefited to the Canadian and Australian dollars) but the share of the Euro remained practically unchanged (27,3 vs 27,2%). At the moment, there is no sign that the Euro could loose its status as a reserve currency. As a matter of fact, this is very much in line with Chinese interests, who played an important stabilizing role at the peak of the crisis. All this could open a rare phase of stability on the exchange markets… before the next upswing of the Euro.

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Default? Short or Long, the Answer is "No"

Two months after European leaders unveiled a "shock and awe" €750bn rescue package to restore confidence in the Eurozone, investors remain nervous: yields on 10-year Greek bond again exceeded 10% at the end of June, yields on the bonds of the peripheral economies of Ireland, Spain and Portugal have risen since early May when the rescue package was launched. Many still believe that Greece (and possibly others countries) will have no other solution than to default sometime in the near future. You can imagine extreme political or international events which could make such a prophecy a reality. But my point here is that a Greek default would definitely not be just another step in the same direction, it could only take place in a much more troubled and disorganized financial world than the one we are presently facing. Look at the arguments.

The argument in favor of an organized default for Greece is based on the simple maths of debt dynamics. First, even with drastic austerity measures, and due to persistently high interest rates and low nominal growth, the debt/GDP ratio would reach a very high level (say, around 130%) in 2013. Second, the primary surplus needed to stabilize the debt ratio at that level would be excessively high; would for example the interest rate exceed the growth rate by 2%, the primary surplus should be 2,6%. In contrast, an organized default would supposedly enlarge the room that Greek authorities have to maneuver by reducing the medium term debt/GDP ratio and the short term required primary surplus. Unfortunately, this is too naive a cost-benefit assessment!

Even "organized", a default, to have powerful effects, should be significant, say 1/3, and its associated costs are huge.

- Following a default, Greece would, according to experience, have no more access to external financing and should consequently, even in a monetary Union, exclusively rely on its own resources to finance its expenditures; this would mean a drastic contraction of internal demand. Default is unlikely only because investors would not benevolently accept the Greek government being be better off after default and the Greek government has no incentive to choose an even harder road. Viewed with the interest of Greece and Greeks in mind, the harsh medicine designed in May in

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cooperation with the EU and the IMF is the less damaging option.

- Given the structure of Greek bonds' detention, default would produce tens of billions in losses for European banks (in Greece, naturally, France, Germany, Italy…), washing out their whole profits, pushing the whole industry into distress, requiring new capital injections, increasing government intervention and finally adding another layer of public debt. Viewed with the interest of financial stability in the Euro Area in mind, organized default is definitely not an attractive option for European policymakers.

- On top of that, we would rapidly see the contagion effects which proved so egregious this spring; spreads would explode; other Euro-area debts would immediately be under threat. But the most dangerous consequence of Greece defaulting would be to immediately and dramatically extend suspicion to other OECD countries (UK, US, Japan) - which until now have raised some benefits from the discredited management of the Eurozone. Viewed with the interest of global financial stability in mind, a Greek default would be extremely bad news not only in Lisbon and Madrid but also in London and Washington. Remember the reasons that President Obama called upon European leaders in May to urge them to find a solution to the Greek debacle; American self-interest is the answer.

The conclusion is crystal clear: the buzz on a possible Greek default is exciting but this will not happen.

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The Political Economy of the Eurozone

We can now return to the most important question, will the Euro area survive the debt crisis? The break-up of the Eurozone was, until recently, an unthinkable scenario; such discussions are now fashionnable. Discussing the likelihood of the scenario is very exciting, but the real trick is to assess its consequences. What you would face is a nightmare which would have economic and financial reverberations that would dwarf the post-Lehman collapse. Deflationary forces of huge magnitude would apply both to weak and strong European economies; the dollar, soaring on huge safe haven capital flows, would impose a new contraction to the US economy and, due to the flexibility of price and wage adjustments, the US would also suffer deflation. The prospects of such markets trauma should give pause to a circular reasoning where unsustainable debts and impotent politicians would only deliver in the future more of what we have witnessed in the spring.

Many thought that the Monetary Union was built on a contradiction, the strict independence of monetary authorities and the rejecttion of fiscal federalism. They conclude that fiscal union being rejectted by the people of Europe, the Euro cannot work. Those adopting this analysis have considered the recent crisis as proof of their perspicacity and their voice has been widely echoed. But the reality is significantly different. What is true is, as mentioned above, that the reconciliation of those two principles was based on extremely weak foundations. A reference to history deserves at that point to be made because this debate about fiscal federalism has already taken place twenty years ago.

Two strong objections had to be surmounted to open the way to the Maastricht treaty which created the single currency. Many in the academic world thought that European countries do not constitute “an optimal monetary arena”, in particular due to the lack of international mobility of labor. The introduction of a common currency was consequently doomed to fail due to divergent agendas and aspirations. Others argued that the currency being the attribute of power, there could not be a strong monetary union without political union. These two arguments are still valuable: the first one says that whatever governments will do to improve the governance of the Eurozone, it will finally fail; the second says that whatever the time it will take the endgame of the monetary union will be a true political union. My guess is that the recent crisis does not add much to these

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arguments because they miss the principal point: despite having no "optimal" economic foundations nor political crowning, the monetary union exists and delivered huge benefits to the European economies.

The principal point – which is frequently poorly understood outside the Eurozone- is the following: given such close trade and capital ties in Europe and given an international financial context where exchange rates volatility continuously put the deepening of those ties at risk, there was simply no alternative to strengthen the domestic market than to adopt the single currency. The objections which were inspired by serious intellectual or political reasons in the '90s were overcome through pragmatic solutions: the stability pact was to safeguard fiscal stability and the Lisbon agenda was to enhance "structural convergence". The fact is that the Stability Pact never reached its objectives; it is particularly striking to observe that France AND Germany agreed to by pass the rules when this was convenient for their own purposes: Greece in effect was not the first to break the rules!

Have we strong reasons to believe that the above cost-benefit analysis of the monetary union has dramatically changed? Have we strong reasons to believe that governments will reject the pragmatic approach which presides to the adoption of rules and governance mechanisms of the Eurozone? The answer to these two questions is "No"; only a closer but pragmatic union is in the interests of European people and business. Leaders have no choice but to draw the lessons of crisis and make a substantial step forward. As soon as next October, the Council will tackle the reform of the Eurozone's governance and transform anew the political economy of the continent.

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The Future "Economic Governance"

We still don't know the future of European economic governance. Investors are skeptical about its future because they don't know what it will mean for Spain, France, Germany and others to live in a close monetary union. We know what it will not be: it will not be a "French idea", which is frequently summarized by a more *dirigiste* power in Brussels (less competition, more social standards, bigger transfers to weak countries), it will not be a "German idea" (a harsh system of rules, backed by heavy sanctions, less German transfers); none of this will happen because the first one is undesirable for a majority and the second is unworkable. Is this particularly bad news? Not at all, it's the more traditional way of doing European politics: common interest calls for a pragmatic compromise. And financial markets frequently underestimated the art of compromise which is *la marque de fabrique* of the European Union.

Now, it's true that there is still a certain lack of clarity regarding what "economic governance" means. Berlin, for example, said that it would rather keep all 27 member states involved but the reality is that the main issue lies within the 16 Eurozone members: don't expect the UK to be part of any budget agreement limiting national autonomy of decision. It will consequently be at the Eurozone level that better surveillance, enhanced prevention measures and new constraining rules will be designed. One way forward is for every country to introduce binding rules to anchor long term discipline and credibility. Now that Germany has adopted its own rules, its partners face a clear dilemma, either follow suit or be punished by the markets. Given the high level of debt in every country, the common interest, emphasizing the credibility of the union, can be more easily than in the previous episode reached through a decentralized mechanism. How could it work smoothly?

The main problem with the stability pact is enforcement. Sanctions did not work and will probably not be the more convincing instrument: "sanctions" cannot be really imposed on democratically elected governments. In any case, the Eurogroup should have increased responsibilities to become a true guardian of fiscal sustainability: the appropriate reference could be an IMF Article IV surveillance process. Consider an interesting proposal offered by the ECB. A "traffic light system" based on independent scrutiny would enlighten the real situation of those countries facing the most threatening difficulties; and, with the experience of the last two quarters, just wait for the consequences on their spreads if those countries do

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not react to their "orange" or even "red" lights! This strategy, sort of a discrete but biting constraint, could be, for the time being, an appropriate way to constrain national sovereignty within democratically acceptable rules.

Now, even with good rules, crises happen. The Eurozone needs to design a crisis resolution mechanism. Under heavy market pressures, governments reluctantly agreed to a massive conditional rescue of Greece and later on, under increased market pressure, on a definitive emergency facility for any other country. The size and more importantly the logic of these initiatives is breath-taking. These agreements, in effect, seem to run contrary to the basic principles of the Maastricht treaty. But this conclusion is wrong. Thinking twice on this issue makes it much less straightforward than trumpeted at the peak of the crisis. Two arguments apply: one, the rescue package is not a bail-out of Greek pensioners, a reward to poor public management. As already described, the rescue is in the best interest of French and German taxpayers who escape the price of rescuing their own national banks. Second, a conditional rescue is definitely not a tax transfer: ask if the adjustment programs adopted under the patronage of the IMF by Latin American or Asian countries have been considered as "transfers"; ask the US Congress if they have ever voted "transfers" to these countries; the reality is that the IMF business is a business which *earns* money. This is the reality which has been finally agreed upon when the German Chancellor asked for the support of her Parliament saying that the extraordinary measures collectively adopted in May and June were serving the best interests of the German tax-payer. The political problem in May was that despite the need for such an instrument it was explicitly but unwisely denied for years. Thus, creating it at the peak of a crisis was not an easy task. German outrage with Greece was no surprise. Now things are following their course and technicalities have to be resolved one after the other. As of mid-July, recall two important elements: the European Facility has been enacted and its boss, Klaus Regling, a former German Treasury official, will by himself inspire respect to the new institution; its operations will be conducted by the German debt agency; these rapid decisions are the clearest available expression of the new balance of power in the European political economy.

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Conclusion

It can easily been said that the future of the Eurozone this summer is still opaque. This is the case as well for other regions of the world; in the US, the recovery is shaky, the aftermath of the financial collapse are always threatening and the control of government finance still an open question as Ben Bernanke himself recently testified before Congress. In China, the stimulus package has fueled a brilliant recovery but the authorities also face huge risks and difficult dilemmas.

By comparison, the shock of the first semester – initiated by a local accident in a small part of the region – has been a precocious test for the whole Eurozone. The following political process has been tortuous and the answers have been difficult to design. The political difficulties which have been witnessed in the spring in designing this new framework should certainly not be minimized, and they are not definitely overcome, but they have clearly been exaggerated, probably in part due to a deadly mismanagement of communication by European authorities.

Anyway, the results are here and they open much brighter perspectives than before. Budgetary and monetary policies as well as the exchange rate are on a solid footing. The results of the stress tests applied to 91 European banks bring another contribution to the restoration of confidence. Nearly everyone praised the transparency that governed the exercise, in particular in Spain, due to the publication of detailed sovereign debt exposure. There was also sort of a good news in the relatively low level of capital shortfalls.

Significant challenges are still looming. But do not underestimate the reality of a new political economy in the Eurozone: a new policy framework, the implementation of stricter fiscal stability rules under market scrutiny, crisis prevention and management mechanisms already exemplified by the European Financial Stability Facility are huge progresses in the right direction. It is no surprise in this context that risk aversion is declining and that investors are back.

“Invest in the Eurozone”? Now could prove to be good timing, don’t miss it.

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