Introduction

THE EURO AREA IN CRISIS

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The 9th EUROFRAME[1] Conference on economic policy issues in the European Union was held in Kiel on 8 June 2012. The Conference topic was: "The euro area in crisis: challenges for monetary and fiscal policies and prospects for monetary union". Twelve of the papers given at the Conference are released in this issue of the *Revue de l'OFCE/Debates and Policies*.

In 2012, the euro is a failure from many aspects: the euro area is unable to recover the nine percentage points of GDP lost because of the financial crisis; GDP will fall slightly in 2012 and is expected to be stagnant in 2013. In recession times, Member States (MS) are constrained to run austerity policies. Three countries have had to request support from the IMF and Europe, and must implement drastic adjustment plans under the supervision of the Troika (the Commission, the ECB and the IMF). Euro area MS public debts are no longer considered as safe assets; euro-denominated debts have become heterogeneous with financial markets requesting high risk premia on Southern MS government debts. MS economic policies are under permanent financial markets pressure.

The single currency suffers from six original sins, which are difficult to correct:

— According to economic theory, there cannot be a single currency between countries with different economic situations and who wish to keep independent economic policies. The single currency entails introducing economic policy coordination or solidarity mechanisms. Otherwise how to prevent the emergence and persistence of imba-

1. EUROFRAME is a network of ten independent European research institutes: WIFO (Austria), ETLA (Finland), OFCE (France), DIW and IFW (Germany), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland), NIESR (United Kingdom).

lances between countries running large external deficits and other countries running large surpluses? How to handle these situations?

— These mechanisms cannot consist in rigid numerical rules enshrined in a Treaty (such as: public deficits should not exceed 3% of GDP, public debts should not exceed 60% of GDP, structural budgets should be run in balance in the medium term). These mechanisms must be flexible (objectives should be agreed between countries accounting for the economic context) and binding (everyone must comply with commonly agreed decisions). But how may governments with different interests and analyses reach agreement on economic policy strategies?

— There cannot be unconditional solidarity between countries with different social and economic systems. For example, Northern countries may refuse to support Southern countries, blaming them for not having undertaken the necessary reforms, for having let imbalances grow and for being unable to meet their commitments.

— The ECB is not entitled to finance directly governments (Article 123, TFEU); financial solidarity between MS is forbidden (Article 125, TFEU). Thus, each MS has to borrow on financial markets without any guaranteed support from a central bank acting as a "lender of last resort". This raises the risk that some MS may not be able to fulfil their commitments and may default. MS public debt is no longer a safe asset. Financial markets started to realise this from mid-2009. Today, after the experience the Greek default, they request unsustainable interest rates to lend to the most fragile countries, increasing thereby the difficulties of the latter.

— Euro area MS are now under financial markets' judgement and they do not control anymore their interest rates unlike Anglo-Saxon countries or Japan. But financial markets have no macroeconomic expertise, they are, and know that they are, self-fulfilling. However, Northern countries refused a collective guarantee of MS public debts. They consider that the discipline imposed by financial markets is necessary. But disparity among interest rates is arbitrary and costly. In the long term, for instance, a country like Italy should pay on financial markets a premium of around 3% of its GDP as a guarantee to an alleged default risk.

— The 2007-2012 crisis is a deep crisis of financial capitalism, which was calling for a strong policy response from governments to lower the weight of finance and the reliance on public and private debts, to implement a macroeconomic strategy aiming at a return to full employment. But European authorities have denied any questionning of the pre-crisis strategy.

A number of divergences of analyses and policy recommendations emerged during the conference:

— According to some authors, euro area imbalances are due to unwise policies in Southern countries; the latter allowed housing and wage bubbles to rise, while northern countries were carrying out virtuous policies of wage moderation and structural reforms. Southern countries should adopt Northern countries' strategies and implement prolonged austerity policies. For other authors, the single currency allowed for the emergence of twin imbalances: it led to under-valuation of Northern economies, which enabled them to offset excessive fiscal, wage and social domestic austerity by excessive external account surpluses and allowed for the persistence of external deficits in the South; what is needed now is a convergence within the euro area where economic stimulus in the North will facilitate the reduction of external imbalances in the South.

— For some authors, each country should implement policies combining strong fiscal consolidation through public spending cuts and structural reforms (liberalisation of goods and services markets, labour market deregulation), which will offset its depressive effect. For other authors, public deficits should be maintained as long as needed to support output, MS public debts should be guaranteed by the ECB so as to entail a downward convergence of domestic interest rates and to implement a EU-wide growth strategy (in particular through financing environmental transition).

— Some authors even consider that EU solidarity should not be strengthened since it would allow some countries to postpone the necessary reforms and would lead to persistent imbalances, which would induce money creation and inflation. The euro area should implement the Maastricht Treaty more strictly, without solidarity between countries and without government bonds' purchases by the ECB. Germany is already at full employment and hence cannot stimulate its economy. Moreover, it would be of little use to the South, which would not be in a position to sell much more in Germany, given the weakness of their industries. Germany cannot provide a guarantee or finance the whole area. Other authors consider that economic policies errors have been made since the inception of the euro area, generating large disparities within the area, which policy makers should try to reduce today by a coherent strategy embedding solidarity. Europe is a big family, which should show solidarity and accept compromises to continue to live together.

— For some authors, a fiscal union is a prerequisite to the end of the euro area debt crisis, which implies implementing the binding rules enshrined in the Fiscal Pact and some degree of fiscal federalism,

where the Commission and the European Council would control MS fiscal policies. For other authors, MS should keep a large degree of autonomy to run the fiscal policy of their choice, for both democratic and economic efficiency reasons: MS economic situations are too diverse to allow a single fiscal policy. The euro area needs open economic policy coordination, without pre-designed and rigid public finance rules, with the objective of reaching a satisfactory growth, leading to full employment and reducing external imbalances.

Real exchange rate imbalances

The single currency has led to the emergence of permanent exchange rates misalignments within Europe and to the polarisation of external balances. The article by Virginie Coudert, Cécile Couharde and Valérie Mignon: "**Currency misalignments within the euro area**" compares real exchange rates in euro area countries with econometrically estimated equilibrium levels depending on relative labour productivity and external assets. The article shows that in 2010 Greece was overvalued by 20%, Portugal by 14%, Spain by 10%, Italy and 6.5%. Conversely, the real exchange rate was undervalued by 7% in Finland, and by 0.5% in France and Germany. Currency misalignments have widened and become more persistent since the launch of the single currency. They are particularly large in peripheral countries. However, the theoretical basis of this method can be questioned: it does not account for growth and employment needs, especially as concerns the unemployment rate. It takes into account the stock of foreign assets and not the current account balance. This may explain the somewhat surprising result for France.

The article by Vincent Duwicquet, Jacques Mazier and Jamel Saadaoui: "**Exchange Rate Misalignments, Fiscal Federalism and Redistribution: How to Adjust in a Monetary Union**" estimates the real exchange rates variations which would allow simultaneously to reach full employment and a current account in balance. The paper finds that in 2010, Portugal was overvalued by 25%, Greece by 18%, Spain by 15%, France by 12%, while the Netherlands were undervalued by 9%, Austria by 11%, Germany by 22%. One may argue that the equilibrium described by the authors does not take account of requirements from Northern countries who wish to run external surpluses to accumulate foreign assets and finance their pension system in the future. This highlights an economic policy coordination problem: how to manage a monetary system where some countries wish to own large external assets, while financial markets deny that the other countries run high debts. The authors propose to facilitate adjust-

ments in the euro area either by a transfers system from countries in a better situation to countries in a difficult situation, either by increasing the EU budget, which would introduce automatic transfers to countries in difficulty. Of course imbalances would smaller after an asymmetrical shock. But Northern countries refuse a system where they may be permanent contributors, they refuse that countries having made adjustment efforts are forced to subsidise countries which they blame for not having undertaken similar efforts. Another strategy would be to finance by Eurobonds productive investments in the countries in recession. This would not, however, reduce durably imbalances resulting from competitiveness gaps.

Indicators of the crisis

The article by Jasper Lukkezen and Hugo Rojas-Romagosa: "**Stochastic debt sustainability indicators**" reminds us that the public debt-to-GDP ratio remains stationary if GDP growth is higher than the interest rate paid on debt or if the government responds to the increase in debt by reducing the public deficit. Until 1980, nominal interest rates were low relatively to the inflation rate and the growth rate; debt sustainability was not an issue. Since then, the UK, the US, Belgium and the Netherlands have accounted for the debt level in the conduct of their fiscal policy; this would not be the case for Spain and Portugal, where debt has therefore become unsustainable. However, the econometric estimations are run on a very long time period (1946-2010), which weakens the conclusions on Spain: until recently, GDP growth was higher than the interest rate in Spain; debt sustainability has become an issue only since 2009-2010.

The article by Christophe Van Nieuwenhuyze: "**Debts, assets and imbalances in the euro area: An aggregate view**" provides an analysis of assets and liabilities of public and private agents in the euro area. It appears that the area as a whole is in balance. Since the beginning of the crisis, rising public deficits have only offset households' and firms' rising surpluses. On the whole, the euro area suffers from rising disparities of external balances and net external positions rather than from public debt problems. The author proposes a policy consisting in the short term to finance these imbalances by financial flows organised by the ESCB and by budgetary transfers; in the medium term to undertake structural policies (increasing Southern countries' competitiveness, ...).

Fiscal rules

The sovereign debt crisis has led the European Commission and Northern countries to advocate the strengthening of the Stability and Growth Pact (SGP) and to adopt a fiscal pact, which obliges MS to target medium-term structural budgets in balance (or, at least, structural deficits of below 0.5% of GDP) and in the short term to cut their public deficits and debt ratios, if the latter exceed 60% of GDP.

The article by Achim Truger and Henner Will: "**Open to manipulation and pro-cyclical: A detailed analysis of Germany's debt brake**" makes a critical assessment of the German "debt brake" which inspired the European fiscal pact. According to the authors, the 0.35% of GDP limit for structural deficits is arbitrary and will lead public debt to amount to 11.7% of GDP only in the long-term which is neither credible nor optimal. The rule prevents to finance public investment by borrowing. Above all, the rule is neither simple nor transparent, due to the difficulty in assessing structural balances: the Commission is constantly revising its calculation method. Finally, this method underestimates the output gap. It may therefore lead to run pro-cyclical fiscal policies in times of recessions.

The article by Catherine Mathieu and Henri Sterdyniak: "**Do we need fiscal rules?**" addresses the arguments put forward justify fiscal rules. The concern about excessively expansionary fiscal policies advocates for the introduction of a "true" golden rule of public finances, where the structural deficit should be equal to public investment. Macroeconomic stabilisation concerns suggest a rule such as: "public balance must ensure the level of maximum demand, consistent with price stability and an interest rate equal to the rate of growth." According to the authors, there is no evidence that deficits were on the whole excessive, before and since the beginning of the crisis. Most of the proposed fiscal rules are not satisfactory from an economic point of view, since they do not allow to run optimal policies after a shock. The article analyses the experiences of the "golden rule" in the UK and of the SGP in Europe: the UK abandoned the rule during the crisis; the SGP created unnecessary tensions before the crisis, it did not prevent the rise in imbalances in the euro area since it was taking account of external balances and private debts. The article criticises the European fiscal Treaty, based on potential GDP and structural balance concepts, which are theoretically and empirically questionable. The Treaty imposes too rigid medium-term constraints, not allowing public investment to be financed by borrowing, which may impose pro-cyclical fiscal policies and prohibits discretionary fiscal policies needed for full stabilisation. The Treaty requires MS to establish independent

fiscal policy councils, as if economic policy should be run out of the democratic debate.

Monetary and banking issues

Banking regulation is a particularly acute issue today. Here too, there are two opposing views. Does Europe needs to "return to the past", where banks would have to focus their activities in their countries of origin and reduce their activities on financial markets in the benefit of credit distribution, under close supervision of their national authorities? Should Europe instead establish a banking union, where banks would be encouraged to diversify across the EU to spread risks, where supervision would be at the European level, where prudential rules based on balance sheet ratios would be implemented? The first solution draws lessons from the losses suffered by European banks in developing their activities outside their country of origin and in financing speculative activities, but it is not consistent with the Single Market. The second solution induces the risk of a lack of control of the banking system, which would keep large leeway to accommodate prudential standards regardless of the financing needs of the real economies.

The article by Dominique Perrut: "**Global and European Financial Reforms: Assessment and perspectives**" describes and makes a critical assessment of the reforms introduced by the G20 and the EU to improve financial stability after the crisis. Drawing lessons from the financial crisis, their goal is to develop a new prudential model both a macro and micro levels. They include the Basel III ratios, the counter-cyclical prudential norms, some separation between retail banking and market activities, the establishment of clear procedures to solve banking crises and closer supervisions. The author is concerned with the margins of interpretation left to financial institutions, by the complexity of the system put in place in Europe, by the risk of competition between institutions subject to regulation and those who can escape from it, between banks established in the euro area, in the UK or in the US.

Exit strategies

The article by John FitzGerald: "**Financial crisis, economic adjustment and a return to growth in the EU**" analyses the experience of some EU countries having implemented crisis exit strategies in the 1980-1995. The paper shows that growth was often driven by foreign trade through exchange rate depreciation and buoyant economic

environment, both of which are lacking today. The article then analyses the situation of the countries most affected by the crisis. Countries with a largely foreign owned banking sector (Hungary, Estonia) have not experienced the rise in debt experienced by countries where the banking sector was largely domestically owned (Ireland, Spain). The crisis has shown that large external deficits were a source of weakness, even they could be easily financed before 2007. Countries in crisis experienced huge falls in consumption and investment. The collapse of the construction sector strongly increased the unskilled workers' unemployment rate. Public finance improvement is very slow as restrictive policies lower GDP growth and therefore tax revenues. According to the author, consolidating public finances is the priority but the author also recognises that a significant growth rebound is needed, which seems inconsistent with widespread austerity policies. The author estimates that countries must improve their competitiveness by reducing their wages level. The author warns against moving back to a purely national banking system; he considers that an integrated banking system in Europe provides significant efficiency gains. In the long term, the lack of human capital is the main obstacle to growth, particularly in Southern countries where unskilled unemployment is already high, where a strong rebound in the construction sector is not desirable, where generations arriving on the labour market are not sufficiently educated. A huge training effort seems necessary.

Kari Alho's article: "**How to restore the sustainability of the euro zone?**" builds a two-country model with a monetary union and the rest of the world. It determines conditions under which the monetary union is stable in the event of asymmetric shocks. Theoretically, stability is ensured by the price/competitiveness dynamic: the less competitive country sees a fall in domestic output, which lowers domestic wages and restores competitiveness. However, this requires that it does not run simultaneously expansionary fiscal or credit policies. If markets do not discriminate between national debts, a pseudo-equilibrium can be reached where the less competitive country constantly borrows from his partner. In case of markets' discrimination, unstable episodes may take place where a country's debt increases permanently as well the interest rate on government bonds. It is therefore necessary to impose a fiscal rule such as a country must run a restrictive policy when its public debt increases. This may have pervasive effects if the rise in debt is due to a fiscal policy aiming at offsetting the weakness in domestic demand or if a restrictive fiscal policy induces a sharp drop in output leading to an increase of the debt ratio. In case of unsustainable external deficits, the solution lies

in internal devaluation (tax reform improving competitiveness at the expense of lower wages) or in structural reforms (expected to increase competitiveness). The article shows that it is necessary to rethink the euro area functioning rules. However, it does not propose new rules: should they bear on public balances or on external balances? In case of imbalances, should adjustment bear only on the deficit country or should not we consider the responsibility of the surplus country too?

The article of the German Council of Economic Experts: "**The European redemption pact: An illustrative guide**" proposes to establish a fund to guarantee the repayment of public debt above 60% of GDP. Countries with debts above this limit (Austria, Belgium, Cyprus, Spain, France, Malta and the Netherlands), with the exception of countries under an adjustment programme (Greece, Ireland, Portugal), would put together in a fund the share of their debt that exceeds 60% of GDP and, in return, would permanently transfer fiscal resources for repayment in 25 years. Financial markets, reassured, would agree to hold this debt at a rate lower than current rates (the authors consider a rate of 4%, which is pessimistic since France borrowed at 2% in mid-2012). In addition, countries should commit to the fiscal Pact, hence should quickly bring their structural deficit below 0.5% of GDP. Thus, the debt ratio would fall quickly: in 2035, it would reach 58.5% in Belgium (against 97% today), 53.5% in France (instead of 88%), 50% Germany (instead of 82%), 60% in Italy (instead of 120%). However, countries should run strongly restrictive fiscal policies in 2012-2015, which according to the authors' calculations amount to 7 percentage points of GDP for Spain, 5.6 percentage points for France, 4 for the Netherlands, 3 for Italy and Belgium. The article does not analyse the impact of such restrictive policies on activity, making the implicit assumption that the fiscal multiplier is zero. Similarly, it does not consider that Europe may experience episodes of economic downturn over the next 25 years, which may require a softening in the fiscal stance. It does not question the factors which led public debts to rise. Were they a sin that MS should expiate? Or were the rises in public debts necessary in the economic context?

The article by Pier Carlo Padoan, Urban Sila and Paul van den Noord: "**Good and bad equilibria: What can fiscal (and other) policies do?**" builds an analytical model with two equilibria: a good one with high growth, low interest rates and low debt/GDP ratios; a bad one, with low growth, high interest rates and high debt ratio. After a financial shock (such as a sharp increase in public debt), a country may experience a race to the bad equilibrium: the increase in debt worries financial markets and causes a rise in interest rates, it reduces growth, which further increases public debt, where a new interest rate

increases... The authors propose to escape from this spiral by three ways: introducing structural reforms that would boost growth (but do such miraculous reforms really exist?), undertaking an expansionary monetary policy to keep interest rates at a low level, but the case of Southern countries in the euro area, victims of speculation should be distinguished from the case of other countries (Germany, France, UK, US, Japan) which do not suffer from high interest rates; and finally restrictive fiscal policies. The fiscal policy impact is ambiguous in the model. If the fiscal multiplier is high, expansionary policy supports growth, reduces the debt ratio and thereafter interest rates. On the contrary, if the multiplier is low, fiscal consolidation is expansionary as it reduces debt and interest rates. The authors have chosen a multiplier of 0.1, substantially lower than the 0.8 to 1.2 range which can be found in recent works (this evaluation should be increased in the case of policies implemented simultaneously throughout the area). This leads the authors to support current consolidation fiscal policies, which may have depressive effects in the short term but become expansionary in the medium term. According to us, the risk is that this cure will kill the patient before being effective. This is what the examples of Greece, Spain and Portugal in 2012 suggest. Austerity does not reassure financial markets and structural policies have little impact in a situation of economic and social distress.

The article by Stephan Schulmeister: "**The European Monetary Fund: A systemic problem needs a systemic solution**" explains the current crisis by the expansion of financial capitalism which led public debts to rise by imposing higher interest rates than GDP growth rates; companies prefer financial investments to productive investment; they refuse to be more indebted in net terms while households continue to save; hence governments must accept higher public debt; financial instability and speculation increase simultaneously. Fiscal austerity policies lead to recession and cannot reduce the public debt burden. Monitoring by the financial markets is currently contra-productive and self-fulfilling. The paper proposes to launch a European Monetary Fund (EMF) lending to MS by issuing euro-bonds guaranteed by MS and by the ECB. The EMF would have to maintain long-term interest rates slightly below the long-term growth rate. Each country's financing would not be subject to a numerical constraint, but would be agreed within the EMF by the MS finance ministers. According to simulations with a macro-econometric model, this agreement would lead to higher growth and lower debt ratios than current austerity policies. But can long-term interest rates be stabilised at a low level, independently of monetary policy? Finance ministers would have the responsibility to agree on deficit targets for each country,

which is problematic (what to do in case of diverging interests or macroeconomic strategies between countries?), not democratic (each finance minister would have to impose to the national Parliament the fulfilment of an objective set at the European level), difficult to implement (what to do in case of a specific or global shock?).

Is the crisis over?

In late 2012, two contrasting assessments can be made of the crisis. On the one hand, the euro survived. Of course, European Institutions and MS policy answers have been slow and hesitant; their hesitation often fed speculation. But European Institutions have gradually managed to develop solidarity mechanisms, such as the EFSF and the ESM, they succeeded to impose MS a strong fiscal discipline (strengthening of the Stability Pact, adjustment programmes, fiscal Treaty). MS have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the ECB has agreed to implement unconventional monetary policies and has supported public debt in countries in difficulty by intervening in secondary markets. Later on, the ECB made a commitment to support without limit troubled countries accepting to implement the requested policies, which helped to reassure financial markets and lowered risk premia.

On the other hand, the euro area is unable to find a satisfactory growth, unable to recover the nine percentage points of activity lost because of the crisis. MS have been forced to implement austerity policies during a recession. According to the Commission's own forecasts, the unemployment rate will remain at 11.8% in 2013. Imbalances between countries persist, even if they are somewhat reduced by the huge depression in Southern countries. Rigid rules lacking economic foundation imposed on MS cannot replace real economic policy coordination. Solidarity is conditional to the loss of domestic autonomy and to the implementation of drastic austerity plans in helped countries. In the future, national policies will be paralysed by European constraints and financial markets' threats. Social Europe does not make any progress. Even worse, Europe imposes countries in difficulty to undermine health insurance universality, to reduce unemployment and family benefits and pensions. Tax competition continues. The crisis has not been an opportunity to question tax havens and tax evasion. Certainly, Europe is at the forefront of the fight against climate change, but it does not clearly move forward in terms of environmental transition. Many MS suffer from deindustrialisation without any EU industrial policy strategy being implemented. A banking union will be established, without being democratically

debated. European authorities persist in a strategy (paralysing national policies, imposing liberal structural reforms) which has so far failed to boost growth and have made Europe unpopular. Europe is missing a social project, a clear economic strategy and a democratic functioning.

Acknowledgements

We would like to thank all contributors to this volume and to the EUROFRAME Conference. We would like to thank the Scientific Committee members for their involvement in the preparation of the Conference; the anonymous reviewers; the authors who have agreed to produce revised versions of their papers in tight deadlines; the participants at the Conference for the stimulating discussions.

The 9th EUROFRAME Conference was kindly hosted by our IfW colleagues, and benefited from financial support from Veolia environment.

The preparation of the volume was ensured by OFCE. We would like to thank everyone involved in the work, and especially Nathalie Ovide, who co-ordinated the secretarial work, Esther Benbassat, Amel Falah, Claudine Houdin, Valérie Richard, and Najette Moummi who took care of finalising the volume.