

## **Saving for Germany?**

### **A European Economic Government alone doesn't solve the EU's problems**

*By Rainer Emschermann, 10.Dec.2011*

International media are warming up for the crisis summit. The demands of the internationally read press, in particular the British, are directed to Germany. Merkel is expected to deliver the silver bullet for coping with the crises, a bullet which nobody would even dare to consider the UK contributing an equal share to. Thus, no matter how the summit will end, the culprit is already found: a treaty revision would be a German Diktat, the failure to reach a sustainable solution a result of German petty nationalism. Only an unlimited license for the ECB to buy sovereign Euro-zone bonds could hope to find the press's mercy as a late conversion.

This perspective, which is presented with an increasing aggressiveness, is not purely distinct from interests: first, British banks and insurances are interested in the short- and medium term safeguard of their sizable investments in the crisis countries; guaranties, which should preferably be made by other governments; against these tangible concerns, the longer-term stability of the Eurozone appears less prominent. Secondly, the UK fears to be pushed to the European periphery by stronger Eurozone integration; there are few qualms left to ally with South European national feelings, in order to abduct these countries from the European core by giving hope to softer path of consolidation. One should ask oneself how long we can afford leaving British media the de-facto monopoly of English language reporting.

Polemics aside, Europe needs British liberalism to balance French *dirigisme*. Moreover, there is one justified criticism in the above: The Eurozone still owes the world a concept for the short term management of the crisis. Economic government and Eurobonds – both concepts are only for the medium term. The rescue fund is facing serious problems. And most of all: the abstract governance concepts do not address the core of the crisis: the necessary consolidation of national budgets. So indeed, there is only the ECB to intervene in order to stabilise markets in the short run.

Left populists are currently pretending the option of a pain free recovery. The economy should not be cooled down harshly, they say. But a country has the option to save as well as to raise its revenue in a fashion that need not seriously harm the economy, by increasing taxes on heritage, real estate, transactions, or by selling state property. Moreover, economic sentiment can be stimulated not only by investments, but even better by market- and administrative reforms. We are observing less of a problem of the business cycle but one of competitiveness. The massive trade- and budget deficits of some countries persist stubbornly.

The populists' solidarity is built on borrowing, because Eurobonds and investment programmes are exactly not the honest transfers they claim to be. Those who criticise the fake nature of the financial markets most do not themselves apply a arguments of the „real economy“, in which each expense needs to be compensated by savings elsewhere. But how if not by internal devaluation and less consumption (in the economic sense) will it be possible to finance new investment? How else are the trade deficits to be reduced as rapidly as necessary? How to prevent that the living beyond own means is financed day by day by EFSF loans and the ECB liquidity system? The latter has seen an increase in Bundesbank claims against Italy by € 100 billion in the space of merely 3 months. Through the so-called "Target system", the Bundesbank as an arm of the ECB now holds the incredible sum of 450 billion € in claims to, in particular Ireland, Italy, Greece, Spain and Portugal; this amounts to almost 20% of German GDP; trend: increasing rapidly. This process has no breaks, as the US-Fed system,

which puts the breaks on such inter-central bank lending by requiring compensation by marketable assets. On top of all this one still has to count the current ECB interventions on secondary bond markets, which are not purely monetary interventions but transfers of real property risks. These are dimensions which are inverting political dependencies from debtor to creditor into a dependency of the creditor to the debtor.

### **Political Pressure Instead of Market Pressure?**

In building a policy for consolidation, the Franco-German "automatic economic government" builds on political pressure instead of the market, taming the latter with short-term liquidity aid for the concerned countries. Will it fly? Well, we have been experiencing an economic government since two years now at the level of heads of state and government. Since two years we are looking eye-to-eye with the abyss. And since two years budget consolidation is too slow to re-build trust. The lowering of the deficit estimates for Portugal from 9,5% to 7,5% earlier this year was celebrated as a "nice success for Portugal"; shortly afterwards the country came under the bail-out fund. Also in Italy it was not the European economic government which triggered reforms, but the disquiet of the financial markets – then, however, the government acted within just days. And Belgium was heading for budgetary crisis for more than one-and-a-half years; the EU threatened penalty payments – nothing happened. Then, on a Friday afternoon, agencies degraded Belgium's market rating. At lunchtime on Saturday the austerity budget was agreed, three days later a government was sworn in.

Hopes that the European Commission as an independent agency could act more effectively than European Councils facing the abyss are wishful thinking: Assuming it could or would lean against a majority of member states ignores its role and identity. Moreover, such a majority will quickly also include more solid countries: everybody will face an election campaign at some point; the German government was a case in point with its proposals for a national tax relief, which flies in the face of lowering public debt standing at some 80% of GDP. Finally, the recent breaching of the spirit of the EU Treaty's no-bail-out clause, which was led by the Commission, has proven that German legalistic thinking may be easily steamrolled by political realities – especially if a "fiscal union" is considered an imposition in southern Europe. Those, who still believe in the effectiveness of economic government, even if "automatic", need to provide better arguments.

The economic government even increases the risks for consolidation, because the term today translates into Greek, Portuguese, Italian, Spanish and soon maybe even into French as "saving for Germany". It is entirely normal that each national public interprets the crisis according to its own realities and interests. In Southern Europe, increasing groups on the political left and right consider themselves as victims of the crisis; the more considerate political centre is shrinking. Angela Merkel is the probably most-hated politician in the region. That is little surprising: The principle to shoot the messenger – which Merkel had condoned to herself when, in May 2010 she had participated in blaming "speculators" for the crisis – remains of course valid after the Eurozone itself has now assumed "big time" the role of creditors from speculators.

This is devastating for consolidation in the crisis countries: saving in favour of other countries which are perceived as being richer, is political suicide: no politician will like to see herself/himself blamed to act as an "agent" of a foreign power. This is therefore the central paradox: the more debt the northern countries assume from the crisis countries the more dependent they become of them and the more difficult consolidation will be. The danger of

default of a country is postponed at the price of a possible crash that could bust both the Euro and the EU. Take the example of Italy: PM Mario Monti has no won parliamentary majority. It remains entirely unclear how he will impose a serious reform programme if he cannot count on the pressure from the market. In the case of far-reaching guarantees, e.g. by the ECB, Montis programme would be dead as can be.

Latvia has shown that a country that de-facto has the Euro (the Latvian currency is pegged to the Euro) can do an internal adjustment. After an economic recession of 18%, a multiple of the Greek one, and with reforms which included a 50% cut in public administrative expenditure, the country came back to an impressive growth after less than 3 years. The fact that discussions in European media do not focus on such cases, but on the possible external saviours, are rather telling. Instead, the view of the crisis as a natural disaster makes victims of the deficit countries and turns the hesitant – and themselves vulnerable Northern Europeans into the perpetrators. Pressure on the ECB is mounting.

### **ECB Interventions and Inflationary Risks**

It cannot be repeated often enough: Financial markets are markets of the future. A government which can credibly assure that it will pay back its loans, will, in the medium term, always be able to refinance itself. A credible readjustment programme, which does not delay reforms into the future, can decrease interest rates with immediate effect. Inversely, already an expectation that the ECB might massively intervene in bond markets, may trigger expectations of inflation and increase the interest levels immediately as well and thereby increase the budgetary pains in some countries.

It is dangerous to play off growth and inflation against each other. If you don't attribute Germany's economic success not primarily to some sort of "Teutonic superiority", one cannot deny that price stability has been a key factor for the economy, allowing it to invest cheaply. Let's not forget: the prospect for all member states to participate in this advantage which was and remains the central raison d'être of a monetary union composed of such different economies. Questioning this achievement would undermine the prosperity and the political endurance of the EU in the longer run.

### **Re-Capitalise the Banks!**

The German government's crisis management is dangerous because it plays for time, because time works against it. A default of Southern European countries would spread through the banking system and quickly reach also Germany. European banks must therefore urgently be stabilised – in the European interest as well as in the German one. Chauvinist boasting, which is occasionally heard in Germany's conservative circles, only shows that these people overrate Germany's cards. Overrating Germany means underrating the systemic crisis.

European banks are owners of risky sovereign bonds; at the same time they are undercapitalised by international comparison: they are to build up only 9% of core capital until mid-2012; moreover, the long delay leads, instead to an increase in core capital, to a shortening of balance sheets with the obvious negative effects on lending and the real economy. The low core capital ratio (Turkish banks hold some 16%, the UK and Switzerland are aiming for even higher values) means an extremely high risk of contagion, which may spread from individual countries to the rest of the EU. This is the crisis' "systemic" threat.

Despite all of this, the federal government and other European leaders have so far not undertaken any targeted action to contain these risks; one appears to prefer waiting until the damage is done, and then to rescue banks ad hoc with public funds, as in 2008. This is unjust and myopic. It is unjust, because it burdens the tax payer with all risks, without letting him participate in the opportunities of the rescued institutions. It is myopic, because a responsible policy would aim at pre-empting a financial crisis, also in other countries. Where the state is not able to do so, European funds should be utilised. The European bail-out fund already allows for this in principle. It should be put to use.

Two steps are required: first, National law has to enable the possibility of a re-capitalisation with new core capital even against the objections of current shareholders. This can be justified by the overriding public interest. Secondly, sovereign bonds currently do not influence the calculation of core capital ratios. Therefore, the re-capitalisation should focus on buffering these risks. This could complement the European Council decision of October 26, which relates to the traditional risk calculations. In order to prevent negative effects on the bond markets, this obligation should relate to portfolios as they were held at a date in the recent past.

Shareholders will obviously object. Their current position is comfortable, if they are considered systemically relevant: in case of problems, the tax payer will come to their rescue. Increasing capital means to water down the value of existing shares or a higher liability. But this is exactly the interest of the taxpayer. Germany needs a legal provision for this. Moreover, effective limitation of risks also means an obligation to diversify risks: sovereign bonds should be included more prominently into the risk calculation of banks. Moreover, financial institutions should be prevented from holding more than a certain share, i.e. 20%, of a single risk, e.g. bonds issued by "their" governments.

### **The Crisis as a Possible Crisis of Democracy**

In case the German government's current high-risk strategy would fail, there is no effective protection of Germany and other countries than a robustly capitalised banking sector. A rescue operation for banks along the 2008 model would again result in a massive participation of taxpayers in this sector's risks but not in this sector's opportunities and thereby trigger an unacceptable regressive redistribution. Paying this bill would be seen as "saving for Europe" and "saving for the banks". Nationalist and extreme left forces would benefit from this radicalisation of the political landscape; the pro-European parties would have to pay a hefty political price. By this token, the issue of financing the deficits of the Eurozone is not least also a conflict about the distribution of its political costs.

The crisis is not a natural disaster. It is a credibility problem which can only be addressed by the deficit countries. New treaties do not change anything about this. They are worth only the political support they will receive in member states. Forced treaty changes are worth little. Europe cannot recover by Germany's solidarity. Even representatives of the political left should be horrified of the image of Germany as Europe's creditor. It is better to be unjustly criticised by Europe today rather than for the right reasons tomorrow.

### **Through the Crisis in three Years: Internal Devaluation in Latvia 2009-2011**

The crisis is often presented as a „Euro-crisis“, mainly because members of the monetary union cannot simply de-value their currency any more. The example of Latvia invites for a more differentiated perspective: Latvia has about 4 million inhabitants. Its currency, the Lat, is pegged to the Euro, its economy is largely euroised. When the crisis hit, Latvia had the choice between leaving the Euro-peg and to de-value its currency, or to devalue internally. Latvia's example of a conscious choice for internal devaluation shows that overcoming the European crisis requires less treaty revisions and political determination.

Latvia's current account deficit assumed 22% in 2007. It afforded living standards beyond its means which financial markets were no longer ready to finance. In 2008 Latvia had to go for an IMF stand-by loan. The adjustment programme assumed a negative growth of 5% for 2009 and availed a credit of €7,5 bn, which was partially financed by the EU and individual other countries (transposed to the size of Greece, this would be a volume of approx. 30 bn €).

Then, however, the economy collapsed by a whopping 18%. The government reacted immediately: it reduced the number of municipalities from 500 to 100, the number of agencies by 85% and overall government administrative expenditure by 50% in two years. Salaries in the public and private sector decreased by more than 1/5, 20.000 state employees were licensed, unemployment went up to almost 20%.

It paid off quickly. Imports decreased dramatically and despite the global crisis exports went up fast; the current account balanced. Despite the worse-than-expected economic development all fiscal target were hit exactly; of the envisaged € 7,5bn only €4,4 bn had to be paid. The *currency peg* with the Euro held firm. In 2010 the government was re-elected. Latest growth estimates are at 6% for the third quarter of 2011.

The Latvian example shows that an internal devaluation is possible and that, if it happens quickly and – admittedly – painfully, a quick recovery to solid growth is possible. Leszek Balcerowicz, the father of the Polish economic wonder of the 1990ies, concluded already in 1995 that quick reforms are preferable to gradual ones particularly from an economic perspective, but also from a political one. Transitional higher unemployment is an inevitable consequence of reforms in a bloated public sector. The important point is to re-instil employees and economic actors with a confidence for a better future.

John Fitzgerald, Irish professor of economics points out the comparatively similar cases of Ireland and Latvia: in 2010 Ireland also had an economic crash by some 18% of GDP. There are, however, two main differences: Latvian banks were in foreign hands; their crisis did not cost the Latvian government much. Moreover, the Irish programme is scheduled for 8 years, the Latvia had only 3. Fitzgerald: History is likely to judge that the Latvian programme was the better one. The Latvian case therefore also shows that mastering the crisis may require less treaty changes but more political boldness.

## **Eurobonds: Solidarity on Tick**

On 23 November 2011 the European Commission presented its proposals for the introduction of "stability bonds". (Let's call them "Eurobonds" nonetheless: had we been assuming that sovereign bonds were safe, the new bonds are now "really very, very safe".) Three options are described: a) exchange of all Eurozone national debt against the new bonds, which are to be guaranteed jointly („joint and several“), b) 40% to 60% of national debt is guaranteed jointly, while the rest will remain in the national responsibility, and c) joint bonds, in which the coupon is shared, but each country guarantees only its own share; the latter option provides such a low interest advantage that not even the Commission appears to believe in it. The objective of the proposal is to deepen the market of sovereign bonds held in Euros, which might yield a "liquidity advantage" and an – average – decrease of the cost of public debt. Countries like Germany, which would now have to pay more for their debt, could be compensated by the others.

The idea of common bonds presupposes that it would trigger not weaker but stronger incentives for solid budget policy, in order to avoid that some member states would indebted themselves at the expense of others. Options (a) and (b) would obviously violate the TU-Treaty's no-bail-out clause. Therefore even the Commission considers the necessity of a Treaty change as "probable". The easy-going way in which some Southern European politicians demand the Eurobonds without Treaty change will not endear the idea to those who are supposed to share the risk.

In any case, the wide-spread hope that Eurobonds could be an elegant way out of the crisis, are misplaced. Let's exclude cheeky option (a), which exists neither in German nor American fiscal federalism; let's also exclude option (c). Option (b) would give Eurobonds a preferred status. That means that as securities of a country would be concentrated in Eurobonds, all of the country's default risk would remain within the share of debt that remains issued nationally. The safe result for the latter is: double-digit interest rates. While the Commission presents this correctly as a particular incentive for fiscal consolidation, it results in little change to the over-all debt burden of crisis countries, if, as the Commission implies, countries that lose from the mechanism would be compensated. Conversely, this means that one has to consider also the currently high national interest rates as an important incentive for consolidation. Giving it up without a comparable replacement pursues other objectives.

In short, for a interest advantage of between 0,1% to 0,4%, which can sometimes be obtained within a single day by an important political announcement, Eurobonds-cum-treaty change appear to be absurdly heavy. Nevertheless: nothing prevents interested countries such as Spain, Italy and Portugal to jointly issue Eurobonds outside the Treaty in order to achieve a liquidity bonus. A success of this undertaking would certainly be desirable and could lure other countries into the boat - voluntarily.