Shaping Europe's economic future with solidarity and responsibility. A German perspective.

Ambassador Dr. Joachim Rücker comments on fiscal policy, monetary policy and regulation issues in the Eurogroup, EU and beyond. What's the role of the common currency in this context? And how do national responsibility and European solidarity complement each other?
The lecture was being held at the Stockholm School of Economics, February 22th, 2011.

I. Intro

Europe's economic future: in spite of the effects of the first financial crisis from 2008 and the effects of the second financial crisis in the Eurogroup from 2010 the outlook is not so bad.

In June 2010, European Council adopted the Europe 2020 strategy, which replaced the former "Lisbon strategy", in order to strengthen the EU's competitiveness in a rapidly changing world economy where economic power is shifting from the EU and the US to Asia and Latin America, to the BRIC countries.

We set ourselves five ambitious EU level targets, to be translated into national targets, on inclusive employment, R&D, climate&energy, education and inclusive societies.

The strategy is linked with the so called Stability and Growth Pact, which is mainly about financial discipline, and part of the EU's new "constitution" from 2009 commonly known as the Lisbon Treaty (SWE presidency!). We will talk more about the SGP.

So we have a good strategy to stay competitive. We, the EU as a whole, have also managed to come out of the crisis, or crises, quite well when it comes to economic performance

Yes, there are differences. Germany, and of course the "tiger economy" Sweden, are doing better than others, but all in all the EU is on a good track (Eurogroup and EU 27 2010 almost + 2%) - IF it wasn't for the risks emanating from the *global financial crisis 2008* and the *Eurogroup crisis from 2010*. So now we have to speak about these risks and measures to mitigate them and, of course, all that with due respect to the German perspective.

II. The first financial crisis

Let me start with the global financial crisis from 2008 and its after effects. We are dealing with them in different global fora like the G 20, currently - just like the G 8 - under French chairmanship. You have seen the reports from the G 20 meeting in Paris last Friday. Among other things, the G 20 is currently trying to define indicators for measuring macroeconomic imbalances ultimately as a means of overcoming "excessive imbalances". For Germany it is important that a good competitive position, resulting in current account or trade surpluses, cannot be subject to any kind of sanctions if it was achieved without state manipulation e.g. of the exchange rate.

From an analytical point of view, we must look at three key policy fields when talking about causes and remedies for the global financial crisis:

- Fiscal policy
- Regulation and
- Monetary policy.

While wrong fiscal policies were not a root cause for 2008, wrong regulation and monetary policies certainly were.

When it comes to remedies, all three policy fields are highly relevant.

In this context I would argue that now, in 2011, there is a global convergence when it comes to the fiscal policy and regulation agendas.

This was not always the case. Talking about *fiscal policy*, it was, of course, inevitable to *support the banks* and *stimulate the economy* with huge amounts of state money, which led to an explosion in public debt. However, some kept their foot on the accelerator, while Germany (like Sweden) argued for early exit strategies and even introduced a "debt brake" in its constitution. There was much criticism for that. Meanwhile, everybody is convinced that exit strategies and debt brakes are actually a prerequisite for economic growth and not vice versa.

Talking about *regulation*, the agenda has also become quite focused and agreeable, at least in principle. As a key example I want to mention the new

Basel III capital requirements for banks; of course the agenda is wider and includes other interesting issues like solving the “too big to fail” problem.

When it comes to *monetary policy*, I am not so sure whether we see convergence. For a start, I do not see any consolidated view on the *diagnosis* side: to what degree have expansive monetary policies been responsible for the crisis? How, exactly, do monetary policies affect asset prices? As a consequence of this, there is no consolidated view on the *therapy* side either. Maybe most important, different central banks have different degrees of independence. Germany, like Sweden, believes in a central bank which is rule bound, keeping inflation in check, and totally independent from political influence. We think that the ECB is doing fine in this regard and we are determined to keep it that way.

III. The second financial crisis

Let me now turn to the Eurozone crisis from 2010. It was *not about wrong regulation* and it was *not about wrong monetary policies*. It was about *wrong fiscal policies* – not in the Eurogroup as a whole, but in some countries. In this sense,what some people are calling the Eurocrisis is not really a crisis of the Euro. It is a debt crisis, not more, not less. This is demonstrated by the fact that the external and the internal value of Europe’s common currency – despite all the turmoil – has remained impressively stable.

Of course, the SGP was there since the beginning of the European Monetary Union and even before. It was and still is about fiscal discipline as a prerequisite for growth, with both *preventive* and *corrective* elements, requiring *all* member states of the EU to avoid “excessive” public deficits, defined as more than 3% of GDP in the annual budget and more than 60% of GDP in total.

Unfortunately, the pact was not fully respected and in the Eurogroup this mattered much more than in the rest of the EU countries with national currencies. Admittedly, part of the blame goes to Germany and France, who in 2004 softened the rules when they had deficits exceeding the 3% limit. (We learned our lesson, though, and introduced the “debt brake”in 2009.)

Later it became known that Greece had manipulated its deficit reporting. In addition, the Euro countries, like others, were incurring huge new deficits to

combat the global financial crisis, which prompted the Commission to temporarily suspend the SGP deficit rules. And of course, in this way, the first crisis influenced the second crisis.

In any case, this lead to a new development from the beginning of 2009. While before the Eurogroup was seen as a whole and interest rates for Eurogroup countries' state bonds did not differ much, investors now started to discriminate, assess the financial position of each of the Eurogroup countries and ask for higher yields from countries they considered risky. This, in turn, led to an even higher debt burden for those countries.

As you all know, this culminated in early 2010 in Greece being unable to refinance itself on the financial markets. It was up to its partners to come up with a rescue plan. The EU's 27, and in particular the Eurogroup's then 16 member states including Greece, met that challenge. What happened? On the one hand, we pledged *solidarity* and underlined our commitment to the Euro project. And on the other hand we took *responsibility*. The IMF and the European Commission visited Greece to establish the facts, which resulted in a 110 bn Euro guaranteed loans package with an unprecedented Greek savings plan. More than 20 bn Euro from this package came, and still come, from Germany.

There was, at the time, some criticism towards Germany along the "too little too late" lines. But then, how could we have explained a "blank check" to our taxpayers? It was necessary to establish the figures first.

And then, in early May 2010, came the next wave, or, as some put it, after the *umbrella for Greece* came the *umbrella for all*. There was now intensive speculation about other countries not being able to refinance themselves any longer. Once again, Europe's leaders rose to the challenge with *solidarity* and *responsibility*. They decided to defend the Euro project come what may and provide full-scale stabilization for the entire Eurogroup. The *nominal* financial dimensions of this umbrella are well known, we are talking about 750 bn Euros of potential loans to countries in distress. The Euro countries guaranteed for 440 bn Euros, with Germany alone for 148 bn, the European Commission for 60 bn and the IMF for 250 bn. The 440 bn were to be raised and lent, should the need arise, in the framework of a new agency named European Financial Stability Facility (EFSF).

IV. Stop curing the symptoms; cure the EMU

In this context, Germany had some specific requests with a view to dealing with the roots of the crisis rather than curing symptoms:

First, like others we insisted on sharpening the SGP, its preventive and its corrective side, and arrive at automatic sanctions in cases of violation.

Second, we held that the EFSF should be temporary and expire after three years, i.e. in June 2013. Should we want to come to a permanent anti-crisis mechanism, there should always be

- tough "IMF approved" conditionality like in the case of Greece,
- a "sharp" SGP,
- unanimous decisions on triggering the mechanism ("veto right for the donors"),
- an inclusion of private creditors, who should not rely on taxpayers' bailout, and
- a simplified revision in the Lisbon Treaty, to make it clear that such a mechanism would not violate the famous "no bail out clause" in Article 125.

These elements were *basically* (not necessarily 1:1) confirmed at subsequent EU and Eurogroup meetings from October 2010 until February 2011.

In *October* the European Council decided that from 2013 onwards the temporary EFSF would indeed be replaced by a new permanent anti-crisis-mechanism. In this context, there was agreement-in-principle on strengthening both the *preventive* and the *corrective* arm of the SGP on the following basis:

- First: in the future, *economic policy coordination – also called economic governance - would be intensified*, especially in the Eurogroup, for example through an *early* scrutiny of national budgets, *before* they are actually decided by *national* parliaments. This so called "*European Semester*" has already started with the presentation of the Commission's first Annual Growth Survey in January 2011. This macroeconomic survey

activity is also required under the Europe 2020 strategy, it is the key link between the SGP and the strategy.

- Second: sanctions for non complying countries would be *almost* automatic.

You will have read media reports that before the European Council President Sarkozy and Chancellor Merkel had a meeting in Deauville / France, reaching a bilateral pre-agreement on SGP sanctions on the one hand and on the simplified revision in the Lisbon Treaty on the other hand.

In *November*, Ireland, which had had to support a collapsing banking sector, asked for help and came under the umbrella. The rescue package amounts to 85 bn Euros. Sweden, the UK and Denmark volunteered to support the EFSF. While they were at it, Eurogroup finance ministers also agreed on what they called the general features of the new permanent mechanism, which is referred to as the “European Stability Mechanism” (ESM). They confirmed unanimous decision making and elaborated on the issue of how private creditors could be included.

In *December*, the European Council endorsed all of this and asked that all the works be finalized in the first half of 2011. Very important for Germany, the Council agreed that a simplified revision procedure for the Lisbon Treaty should be initiated and completed in time, by 2013. Through this revision, financial emergency measures would be based on Article 136 rather than on Article 122 of the Lisbon Treaty, more precisely of the Treaty on the Functioning of the European Union (TFEU).

In *February*, less than three weeks ago, the special meeting of the European Council decided that the “general approach” on intensified *economic governance* as part of a strengthened SGP should be ready by the end of March and finalized by end of June. Also by the end of March, the Council would adopt the final decision on the simplified treaty change for the ESM, while Eurogroup members pledged to finalize the ESM’s operational design until then.

V. Latest developments

Two things had happened, though, between the December summit and the February summit and I would like to draw your attention to it.

First, it became clear that the present guarantees to the EFSF would under no circumstances allow to finance the nominal amount of 440 bn Euros, because countries would not borrow and guarantee at the same time and, *much more important*, because the EFSF would back its bonds only with guarantees from "AAA" countries. These countries are France, the Netherlands, Luxemburg, Austria, Finland and Germany. So there is an ongoing debate now on the "if and how" of bringing the EFSF to its originally intended amount, even if for the time being less than 10% of that have been used. You find that reflected in the Eurogroup's conclusions from 4 February, where they say that by March there should also be "concrete proposals on the strengthening of the EFSF as to ensure the necessary effectiveness to provide adequate support".

At this point, let me explain the German position with regard to the so called "Eurobonds" proposal. It has been argued, and I am simplifying somewhat, that the EFSF with bilateral contributions is only the second best solution when it comes to the costly and - in two cases - unbearable interest rate spreads in the Eurozone. It would be much better to overcome the spreads altogether by pooling our activities and issuing joint "Eurobonds" which would probably result in an adjusted average type interest rate, bearable for all. We do not think this is a good idea. It does not seem to be compatible with the "no bail out" Article and it would de facto trigger what is called a "transfer union" in the German debate. Maybe more important, the SGP obliges all member states to adopt fiscal policies that reflect their responsibility for the common currency. The threat of higher interest rates, expressed in the spreads countries pay on their bonds, functions as an *incentive* or *sanction* to do this. We need to hold on to this mechanism in principle and not just shift the interest rate risk to Community level with Eurobonds or in other forms.

The second thing that happened between the December summit and the February summit is a French-German proposal on a so called "pact for competitiveness". *Undoubtedly, the decisions adopted by the European Council in October and December went beyond short-term crisis management and laid the foundations for lasting stabilization, not least with regard to better economic governance through a sharpened GSP*. However, President Sarkozy and Chancellor Merkel proposed an *additional* approach for better economic governance and coordination, to *supplement* GSP efforts. Their approach is based on voluntary commitments from the 17 Eurogroup members, and others if

they wish, to cooperate in areas of - in principle – continued national responsibility like

- tax rates,
- labor costs,
- retirement ages and
- social policies.

If we go down this path, previous debates on intra-EU or intra-Eurozone "excessive imbalances" in current or trade accounts – the "micro-version" of the G 20 debate - would subside. I note that this debate has become much calmer anyway, especially since it became clear that Germany's current growth is very substantially based and domestic demand and not on exports alone.

In any case, you find the "pact for competitiveness" reflected in the Eurogroup's conclusions from 4 February, where they say that on this "*new quality of economic policy coordination*" the President of the European Council will undertake relevant consultations, "identifying concrete ways forward in line with the Treaty."

The Swedish government criticized the proposal, partly because it foresees a voluntary cooperation between governments rather than a joint EU effort. We can discuss this.

Probably such discussion will lead to the more fundamental question: is it possible to have a Monetary Union and keep fiscal, budgetary and economic policy largely in the hands of the member states, that is: is it possible to have a Monetary Union without what the French call "*economic government*"?

The first answer to this question is "yes, it is possible, if some basic rules on *economic governance*, like in the SGP, are really respected". So of course we have to make the SGP fully effective now.

The second answer to the question is: "things are easier if we *coordinate even closer*, without giving up essential prerogatives like our national parliaments'." So a "new quality of economic policy coordination" is not a bad idea.

VI. The larger picture: the Euro is part of the political project

In fact, as our finance minister Wolfgang Schäuble recently pointed out, the whole history of European integration has followed the model of economic integration steps being followed by - more or less - political integration steps.

The Euro project is a great economic advantage for all of us, not least for Germany. It protects economic actors against exchange rate risks and facilitates trade and investment. It has been an anchor of stability during the global financial crisis and its aftermath.

But it is not only about prosperity. It is also part of the European political project, it is a symbol for an unprecedented period of freedom and peace in Europe.

This is why we are positive that we will not only be able to defend the Euro with *solidarity* and *responsibility* as explained (and sometimes deeds speak louder than words).

We are positive that the current crisis surrounding the Euro will lead to a new quality of European integration and both the Euro and Europe will come out even stronger.

Thank you for listening.