Lessonsfrom thefinancial and economiccrisis andits implications forthe futureof theEU

EMIWorkshop

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Thereasons thatlead tothe crisis

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Theinterplay oftwo crises

- The EU was unable to prevent its financial system from being contaminated by the first crisis, namely the financial crisis which originated in the US. The financial crisis transformed itself quickly into a full fledged economic and social crisis.
- This first crisis hit the EU halfway in its integration process, with several member States in positions of vulnerability due to excessive indebtedness (living beyond their means syndrome), drift in competitivity and inadequate bank supervision.
- The second crisis, namely the sovereign debt crisis in the euro zone, which emerged first in Greece and spread to other vulnerable euro-zone countries, is a crisis associated to specific flaws in the design and implementation of the European Economic and Monetary Union.

Causesof theeconomic andfinancial crisis

- Immediate cause : excessive expansion and laxism in sub-prime mortgage credit market in the US, followed by explosion of real estate bubble.
- Intermediate causes : policy mistakes such as excessive development of credit through securitization (originate and distribute model) , transfer of risk to the wrong investors, excessive leveraging and financial innovation, particularly derivatives (CDS : arms of massive financial destruction) , perverse incentives linked to remuneration system, too-big-to-fail syndrome, macro-economic mistakes, particularly from the Fed but also in Europe and lack of anchor of the international monetary system.
- Ultimate causes of a moral or ideological nature: triumph of neo-liberal ideology, illusion of perfect markets, triumph of spirit of speculation over spirit of enterprise, triumph of shareholders over stakeholders, triumph of finance over industry, excessive search of short term profit, desagregation of consensus about values, general permissiveness, lack of sense of responsibility and of solidarity.

Fromthe financialan deconomi ccrisis of20 08to the sovereigndebt crisis inthe euro-zone

- The financial and economic crisis of 2008-2010 has placed a heavy cost on the budgets and on the competitiveness of the economies in the euro-zone.
- It has also revealed underlying problems and weaknesses in the areas of public and/or private indebtedness and/or loss of competitiveness and/or banking supervision which would in any case have surfaced at some point.
- This is the origin of the perverse nexus between bank indebtedness and sovereign indebtedness.
- To understand the specificity of this second crisis , one has to go back to the reasons why and the conditions under which a number of EU countries have moved to a monetary union.

Reasons tomove froma commonma rketto a monetaryunion

- Objective of creating competitive conditions as similar as possible to those prevailing in the USA for European enterprises : Customs Union, Common Market, Single Market, Economic and Monetary Union, eliminating the exchange risk for trade and investment.
- Realisation that full liberalisation of capital movements would be incompatible with fixed exchange rates and independent monetary policies (triangle of impossibility).
- Political reasons : Kohl-Mitterand deal linking the German reunification and German support for the EMU, desire to give a tangible symbol to EU citizenship, the euro seen as a drive for further political integration.
- Huge potential benefits to be expected from the process of monetary integration in terms of economic policy convergence, integration impact, enhancement of competition and transparency, etc.

Underestimationof whatis requiredto ensure thesustainability ofa monetaryunion

- Underestimation of the challenge of sustaining a monetary union with low level of labour mobility (due to linguistic and cultural obstacles) and a modest budget at the EU level.
- Need for close monitoring and instruments (e.g. incomes policy and structural reforms) to restore competitiveness when the option of devaluation is no more there.
- Need for higher prudential requirements in cases of excessive credit expansion.
- Need for strict and consistent standards of bank supervision to prevent systemic banks from taking irresponsible risks (too-big-to-fail syndrome)

Weaknessof theeconomic pillarof theEMU

- In contrast to monetary policy, Member States retain ultimate responsibility for economic policy within the EMU. There is not a genuine economic government of the Community acting as a single interlocutor to the ECB but only « the adoption of an economic policy based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives »(Article 119 of the TFEU).
- Member States are however required to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union and to act in accordance with the principle of an open market economy with free competition (Article 120 of TFEU).
- Member States have to regard their economic policies as a matter of common concern and to coordinate them within the Council (Article 121 TFEU).

WeakEconomic Governancein theeurozone

- Weak impact of the annual Broad Economic Policy Guidelines;
- Adoption of the Stability and Growth Pact in 1999 : focus placed too exclusely on public finance; weak preventive arm with no sanction; sanctions coming too late in the dissuasive arm, reluctance of the Council of Ministers to apply them; violation of the Pact in 2003 by Germany and France; excessive deficits in Greece, Portugal, Italy but also Belgium and France.
- No sufficient attention given to other macro-economic disequilibria (e.g. private indebtedness and balance of payments disequilibria) and to the drift in competitiveness.
- Failure of financial markets and rating agencies in assessing risks associated with sovereign debt in the eurozone.
- Weakness of the instruments (Open Method of Coordination) to implement the Lisbon strategy, aimed at addressing the underlying weaknesses in the real economy of the EU.

Weaknessof availableinstruments todeal with thecrisis

- The « no bailing out » principle (article 125 TFEU) lead to the absence of mechanism to help euro-zone members in difficulty : still to-day this principle creates a suspicion of illegality of efforts to alleviate the debt of Greece. .
- Medium Term Financial Assistance Facility reserved for countries that were not in the euro (art. 143).
- Limitations in the mandate of the ECB and prohibition of monetary financing of budgetary deficits (art. 123).
- Modest size of the EU budget, limited potential of Cohesion Funds and of the EIB.
- Article 122 al. 2 (natural disasters or exceptional occurrences beyond the control of a member State) had to be interpreted in a creative way to provide a legal basis for assistance.

Thankyou foryour attention