« Europe’s Dilemma in the Present Financial Crisis: Due Democratic Process Facing Mercurial Markets »

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• Purpose of the presentation: To examine the origin and nature of, and the prospects for, the – seemingly - uneven battle between:
  - the 17 countries which make up the EU’s Economic and Monetary Union (EMU); and
  - world financial markets with activities in the eurozone
• A special feature of the EMU construction: One currency but 17 sovereign participating countries.

Hence:

1) an in-built slowness in EMU reactions (with the exception of the European Central Bank (ECB));

2) No independent money-issuing authority for the ECB;

The « one currency - many countries » feature also helps explain why:

- no EMU treaty procedure was foreseen for bail-outs of countries in crisis, or why there couldn’t be any exit clause. (This would have doomed the project from the start);

Therefore, each eurozone agreement on a bail-out requires much time, further adding to the ‘tortoise’ appearance of the EMU project.
So, is the EMU a tortoise? If so, are the financial markets the hare, as in Aesop’s fable?
Q: Did the hare indeed **know** he was dealing with a tortoise?

A: Not necessarily. Most financial market participants did not really reason in terms of individual EMU countries until around 2007, when the interest rate for e.g. Greek bonds began to rise to levels too high for comfort. They reasoned more in terms of the US, seeing (erroneously) the EMU as a quasi-federal construct.

Indeed, the FM hare may well have thought he was dealing with a fellow hare, such as when the Irish and Greek governments began to offer slightly higher (more attractive) interest rates.
• Q: Did the FM hare know he was entering into a race with the EMU tortoise?

• A: Not necessarily, if you consider how positively the international financial markets treated the EMU from its start in 1999 up until around 2007, when markets first began to worry about Ireland and Greece.
• Q: We must assume that the FM hare knew it was, itself, a hare. But can the same be said about the EMU tortoise?
• A: Not necessarily, considering that many EMU countries went on a wild borrowing spree between 2000 and 2007. Indeed, the EMU tortoise – or rather its 17 component body parts - *may well have thought it was a hare!* - and that it therefore felt prepared to propose a race.

The ECB for its part, however, knew the EMU was a tortoise, urging EMU countries to undertake structural reform (labour market flexibility, sector liberalisation ...) to make it more like a hare. But many countries did not listen, especially since times were good. Still, some countries, like Germany, undertook considerable reform. (E.g. Hartz IV.)
• Q: But if the tortoise thought it was a hare and not a tortoise, then could it have known its true identity?

• A: Perhaps not, given its largely defunct ‘nervous system’. Indeed, at the start of the EMU, when times were good, it would largely have been able to run like a hare. Countries only looked at the whole EMU structure, finding it operative. It was only when the crisis hit that the EMU-zone realised its anatomical reality.

- Eurostat tried to gain the authority to check on national financial statistics, only to be turned down by the national authorities, which felt that this constituted an encroachment on national prerogatives.)

- National authorities perhaps felt it would be safe to borrow further and let their deficits grow, due to the massive, ‘unsinkable’ size of the EMU project. (Domestic and foreign banks apparently felt the same.)
Q: But is there really a race?
A: Well, it wasn’t at first, from 1999 to 2007. The only thing markets could really make revenue from was volatility between the euro and other currencies (dollars, Swiss francs, yen … The so-called ‘carry trade’)

Markets actually started to like the euro when some EMU members offered slightly higher interest rates. Thus, the FM hare actually fed the EMU tortoise with funds to governments and banks for many years.

Later on, when interest rates got worryingly high, the markets poured in more funds to insure investors against country debts going bad. So by now, it had become a race!
The race: really a series of smaller ‘sprints’ (lasting sometimes for months) Example: How the tortoise gets through a typical ‘bail-out + firewall sprint’

1) Investors begin to have worries. (Interest rates for the country’s bonds rise to uncomfortable levels);
2) One or more rating agencies lower the country’s rating;
3) The government of the country protests, calling the downgrade unjustified;
4) Markets’ attention is drawn even more to the country’s situation, causing interest rates to rise further. This process continues;
5) The government asks for EMU, and sometimes IMF, assistance;
6) A bailout is a) discussed internationally; b) negotiated; c) agreed by governments; d) parliamentary approval procedures begin; e) all parliaments concerned ratify (including that of the recipient country)
7) Countries agree to build a ‘firewall’ against future contingencies; but the situation may have worsened in the meantime, requiring a higher firewall than at the outset.
8) Only now can the tortoise start moving. But in the meantime, the hare has run a long distance ....
Q: But is it really in the hare’s interest to win this race?
A: Not really, for if the world economy were to suffer greatly – as it surely would if the EMU were to break up – financial markets would, like everybody else, lose money from reduced economic activity and uncertainty about the future.

Markets could gain from penalty-free bail-outs (e.g. Ireland, Portugal, the first Greek bailout of 2010). But they could also lose money, such as in the 2012 Greek bailout (even though a few ‘hold-out’ creditors, who threatened to take Greece to court, got paid in full by the Greek government (mid-May 2012).
The hare may have taken a nap, but financial markets won’t.
• Q: Or, worse, does the hare really stand to gain if the tortoise were to collapse?

• A: No, the hare’s reputation in the forest might suffer greatly, via popular anger at the financial markets and the market economy in general; risk of political unrest, which is always bad for business.
Could the tortoise turn to a coach or a doctor to learn to move faster?
Q: To win the race, could the EMU tortoise, by working hard, turn itself into a hare?
A: Maybe, but it would require some ‘medical care’, such as by:

1) **Speeding up its nervous system** (internal communication), such as via full Eurostat authority to verify national accounts and statistics;

2) **Improving its blood flow** via (suggestions made by various observers):
   a) the creation of ‘eurobonds’ issued by all EMU countries collectively (but resisted by several eurozone members, including on legal grounds at national and EU level);
   b) collective backing of banks (but resisted by some countries)
   c) overall political and economic federalisation (but also resisted by some members). Apparently a proposal is being prepared, for the EU Summit in Brussels, 28-29 June 2012 ... ;
   d) muscle training and loss of ‘excess fat’ in some parts of the EMU body through structural reform, especially in the ‘crisis countries’ (now under way);
   e) longer ‘resting periods’ in certain EMU body parts, such as Germany (e.g. more domestic economic stimulus that could benefit the eurozone as a whole)
• Q: But even if it can, does the EMU tortoise really **want** to become a hare?
• A: Well, that is the big question: popular discontent and political crises in many EMU countries; the rise of extremist parties would indicate that it doesn’t want to …
• However, at the same time structural reforms and attempts at joint action are valiantly being made (bailouts, firewalls). Everybody is waiting to see the light at the end of the tunnel. Will it, can it, come at the EU-Euro Summit at the end of June? The ECB President addressing the European Parliament on 31 May 2012: « Dispel this fog! »
• Meanwhile, the referees - the rating agencies, the markets, the general public - are all waiting at the goal post ....
• Thank you for your attention. Now to the discussion.