

How do we get out of the eurocrisis

**Discussion paper by economists at SAK, STTK, and Akava
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How do we get out of the euro crisis?

The financial crisis in 2008 and its subsequent management have, in certain eurozone member states, resulted in a debt crisis that threatens to develop into a new, even more disastrous banking and financing systems crisis. The consequences of a new crisis would be dramatic, not only for the euro area, but also for the economies of the EU and its member states.

The roots of the euro area crisis originate from the real economy, as did the roots of the financial crisis in 2008, in other words, the crisis is not caused by speculative activities in the financial markets. The monetary union has not narrowed the differences in work productivity or cost competitiveness between the member states. On the contrary, the gaps have widened. A common monetary policy requires disciplined fiscal policies, but the discipline has failed. In most EU states, the public-sector debt burden was growing already before the financial crisis in 2008. The continued trend had not previously worried the financial markets, largely because it was believed that the No Bailout principle would not hold. Additionally, the European Central Bank (ECB) regarded the government bonds of all eurozone states to be equally good as securities.

Apart from the real-economic problems, the currently prevailing crisis involves increasingly the issue of the monetary markets being led to an overreaction by prolonged uncertainty. The uncertainty and instability of the markets are greater than would be justified by the problems existing in the real economy. Therefore, credible political solutions are extremely important in order to stabilize the situation.

Since attempts to find a swift solution to the crisis have not succeeded, the uncertainty is leading the European financial market into a self-fulfilling negative spiral. There are doubts within the market that those eurozone states that are already excessively indebted will not be able to provide their banks with sufficient financing to cover the losses occurring in case a eurozone state fails to meet its obligations. This is why the banks do not trust each others' solvency. Similarly, confidence is eroding as regards the solvency of an increasing number of eurozone states.

It must be recognized that the only way of getting out of the acute crisis is by safeguarding the solvency of the states driven in difficulty and by capitalizing European banks. At the same time, it is necessary to find solutions to the structural problems within the euro area and to restore the credibility of fiscal policy coordination. Therefore, the troubled states must commit to extensive and austere adjustment programmes in order to balance their public sector financing and improve their economic competitiveness. Moreover, the supervision of the financial sector must be reformed and made more effective to match the global nature of the sector. And most of all, it is vital to turn the EU economy toward a steady growth track.

More powerful measures than those used at present will be necessary in order to resolve the acute debt crisis prevailing in Europe. The rehabilitation of the economies of the problem states is a prerequisite for overcoming the crisis for good, but it has become obvious that the adjustment measures alone are not sufficient to immediately calm the markets. Political decision-makers in Europe have not been able to convince the markets that the euro area has the will and ability to mobilize the necessary financial resources to secure the member states' solvency and the banking sector's capacity to act in all circumstances. The stability instruments created for this purpose are not sufficiently extensive to solve the

acute crisis, not even after their latest increases. It is no longer politically possible to increase the size of the stability instruments through national budgets. Nor can any other means on the agenda be used to increase their size, in a credible manner, to such a level that they could both secure the functioning of the banking system and safeguard the solvency of the states. The only sufficiently powerful solution is to increase the stability instruments through the European Central Bank.

Summary of proposals

- The credibility of the Stability and Growth Pact (SGP) must be restored; the “Six Pack” legislative package is necessary.
- It is necessary to create credible contents for the No Bailout principle.
- The eurozone states need a mechanism that will safeguard their solvency.
- European banks must be capitalized in order to prevent a new financial crisis from being triggered by the credit losses resulting from debt rearrangements.
- The capitalization must primarily be realised by the private sector, but public-sector measures are also required.
- The capitalization must ultimately take place at the European level so that a relevant proportion of the banks’ or other financial institutions’ shares is transferred to the possession of taxpayers.
- The stability instruments, i.e., the European Financing Stability Facility (EFSF) and the European Stability Mechanism (ESM), are not sufficiently extensive. Increasing them by means of tax revenues is neither reasonable nor possible.
- The ECB financing must be linked in an operational manner to the stability instruments by, for instance, establishing a bank that operates on a guarantee from the ECB.
- The bank in question would serve as the last resort to secure the solvency of the eurozone states. Moral hazard issues must be considered seriously when planning the bank’s operations. Securing its financing would call for credible adjustment measures.
- The idea of eurobonds could be developed further to serve the growth and competitiveness of the EU on the basis of mutual benefit. The eurobonds are not feasible as crisis-solving instruments.
- Once the acute crisis is over, it will be necessary to correct the internal imbalances of the euro area. In the strong member states within the euro area, domestic demand and purchasing power must be secured by means of wage and salary development that is in line with productivity. In the weaker countries, austere decisions must be made in order to improve competitiveness.
- At the EU level, growth must be promoted by intensifying the internal market integration and the external economic relations of the EU states, including trade policy. At the same time, it is necessary to reinforce the social and environmental dimensions of the EU.
- Coordination of fiscal policies should also be extended to cover tax policies so as to avoid harmful tax competition.

All possible means must be employed to avoid a large-scale banking crisis

The ultimate impact of the debt rearrangement of Greece, and possibly of other troubled countries, and the subsequent multiplicative effects on the functioning capacity of the financing system are not known, which increases the uncertainty of the financial markets. The actual state of the European banking system is also somewhat unclear. The performed stress tests do not answer the question as to whether the European banking system could bear up against the failure of Greece or other countries to pay their debts.

***Banks need additional capital.
Capitalization would calm the markets.***

In order to withstand the consequences of the debt crisis, the banks need additional capital. Capitalization is necessary to secure the stability of the financing system and prevent a bank crisis. It would also calm the markets, as the risk of an immediate new financial crisis would reduce significantly.

To rescue the banks, joint efforts are also needed.

The banks should be capitalized primarily by the private sector and, in particular, by the shareholders of the banks. Banks can be forced to raise additional capital, for example, by tightening their capital requirements in relation to balance-sheet liabilities. Nevertheless, it is unrealistic to assume that private capital alone could, in a credible manner, get the European banking system in shape, so there is a need to focus on public-sector measures as well.

The debate has mostly concerned the issue as to whether the capitalization should mainly be based on national capitalization, meaning, in practice, the use of tax revenue, or on a broader European approach, in which the capitalization would take place through European instruments rather than national budgets. The principle that each state is responsible for the capitalization of banks governed by relevant national legislation is correct, as such, but not necessarily a feasible option. Facing the threat of an extensive bank crisis, an individual national state may be too small an actor to save banks. Even a larger state may be driven to insolvency, if it becomes solely responsible for bank crisis management.

Therefore, in all circumstances, the only credible manner of rescuing the financial system is to instigate measures at the European level. This is a natural approach also because of the fact that banks operate internationally, not just within a single country.

As collateral for capitalization, part of the shares of the banks and other financial institutions should be transferred to the possession of taxpayers. Thus, the shareholders would assume responsibility for not letting the financial institutions be driven into difficulty, the competition in the banking sector would not be distorted, and the taxpayers would gain, in return for their risk-taking, a genuine profit opportunity as the nationalized shares could be sold once the economic situation becomes normal again. During the course of capitalization, the banks receiving additional capital should be deprived the right to pay out dividends to owners. Bonuses and other managerial incentives must not encourage excessive risk-taking. Moreover, they must be reasonable in size.

In order to safeguard the sustainability of the financing system in the future, there is a need for better regulation and supervision than are currently in effect. For example, tighter capital requirements would

add stability. If implemented properly, the taxation of financial transactions would reduce speculation, which increases instability, without causing any detrimental effects on the real economy.

The states' solvency must be secured

The eurozone states need a mechanism that will safeguard their liquidity.

In those countries that have their own central bank, the state can ultimately force the central bank to finance government debts. This possibility is, as such, also a major risk, because continuous money printing will, in the long run, lead to rapid and accelerating inflation. This is why, over the past decades, the developed countries have clearly strengthened the independence of their central banks in relation to policymakers, and also clearly indicated that the main task of the central banks is to maintain price stability. The possibility of the national banks to serve as the last-resort financier for the government, however, still exists.

The possibility of the national banks to serve as the last-resort financier is well known to the markets in such countries as, for example, the United States, Britain and Japan, whose public sector deficits are 8–9 percent of the GDP. Public debt prevails in these countries at a high level, being slightly below 100 percent of the GDP in the USA and UK, and nearly 200 percent of the GDP in Japan. Regardless of these figures, the interest rates for government debts have remained low in these countries. The underlying reasons include, not only confidence in the capability and willingness of policymakers to keep the public economy sound, but also the fact that, in these countries, the state's solvency can at any time be guaranteed by the central bank.

It takes time to implement aid packages aimed at strengthening the public economy, as does the realization of their effects. During this lead-through phase, the states should remain solvent. Additionally, given the nervousness of the financing markets, even ungrounded suspicions may make funding more difficult for those states that have managed their economy quite successfully thus far. This is, in principle, understood, and the ECB has, for some time now, been buying bonds of the eurozone states from the aftermarket in order to prevent their interest rates from rising abruptly. The problem is, however, that the ECB's mandate to act in this fashion has been questioned, and the ECB has not been able to clearly and permanently commit to purchasing bonds from the aftermarket.

Altogether, it is obvious that the euro area requires a mechanism that will safeguard the liquidity of the states and to which the ECB financing is clearly linked. The independence of the ECB must, however, not be limited in any manner that would, later on, hinder its credible commitment to price stability. At this stage of the current crisis, inflation is not a genuine threat, even though the central bank is strongly increasing its money supply. The central bank liquidity can be decreased once the acute phase of the crisis is passed, the banking sector operations have normalized, and the need for central bank financing is becoming normal.

The possibility to resort to a liquidity safeguarding mechanism must be restricted to assistance given in exceptional situations only. This facilitates its use as a tool for managing acute crises and preventing their detrimental consequences, not as a permanent, broad-scale financing resource. The mechanism is thus, due to the inflation risk and moral hazard, not built up to serve as a lending automat for those countries that spend beyond their means.

It is essential to distinguish liquidity problems from problems related to debt-management ability. The need to support liquidity is, however, usually connected with doubts concerning the ability to pay back debts. This is why it is also necessary to assess the need for stabilization measures and eventual debt arrangements whenever a eurozone state resorts to the solvency mechanism. Assistance is only possible if sufficient measures to increase stability are taken immediately, and only for as long as these measures are implemented in the agreed manner.

ECB resources must be taken into effective and responsible use

The size of the stability instruments (EFSF and ESM) must be increased. The capital funds raised by the EFSF and ESM could be used to create a bank guaranteed by the ECB.

It has been agreed that the European Financing Stability Facility (EFSF) and European Stability Mechanism (ESM) shall be modified to make them more effective and flexible. They will be given the capacity to directly lend money to states and to

purchase government bonds from the aftermarket. Once the plans are put in place, the stability instruments can also be used to capitalize banks. The agreed measures toward higher flexibility are steps in the right direction, but they are not enough.

In terms of bank capitalization, the functioning of the EFSF, ESM and the European Central Bank must be reviewed as a whole. Currently, only the ECB has necessary and sufficient resources available to tackle the acute crisis. It is neither economically credible nor politically possible to expand the stability instruments through national budgets. The only operational alternative that remains is to increase the role of the ECB.

For example, part of the capital funds raised by the EFSF and ESM could be used, together with a guarantee from the ECB, to establish a bank that could borrow money directly from the ECB. This is the only way to increase their resources to a sufficiently high level, without the need to finance them using tax revenues. The new bank would constitute the core solvency mechanism for the euro area. If the resources are utilized for the purpose of creating a bank that would operate under the ECB's guarantee, it would safeguard, in all circumstances, both the solvency of eurozone states and sufficient capital funds for the banking sector. That would be an ideal measure to calm the markets. It is absolutely necessary to establish clear game rules for how this bank would operate in practice so that moral hazards could be avoided and the taxpayers' position would be maximally secured. The ECB must have sufficient control over the financing decisions taken by the bank in question.

The Euro must be kept intact

Disintegration of the euro area would increase uncertainty across the entire area, lead to uncontrolled capital escape from southern European countries, explode the already high unemployment figures to an unbearable level, and crash the standard of living.

Several statements on possible solutions propose the separation of Greece and possibly other troubled countries from the Euro. That would, for many reasons, be extremely problematic.

If Greece or any other state started preparing for separation from the Euro, it would result in a significant escape of capital assets and deposits, which would be disastrous for the economy of the country. To prevent an uncontrolled capital escape would require massive capital controls, including restrictions

imposed on cash withdrawals. Expectations of future devaluation would encourage the cashing of bank deposits, with the idea that the euros would keep their value even after the issuance of the national currency. In practice, the entire banking sector should be halted for as long as it takes for Greece to make and endorse decisions concerning a new currency. The resolution process of the Greek parliament, renewal of the banks' computer systems, and printing the new currency would take months. This long a break in the financing market operations would be lethal for the economy.

The separation of one country that is struggling with financing problems would inevitably lead to speculations regarding other countries in a similar situation, which would result in capital outflow from other countries with problems as well.

If a state that has financing problems separates from the Euro, its national currency would be strongly devalued in relation to the Euro. This, again, would mean that it would become even more impossible for the relevant state to manage its debts. In practice, the situation would force the enactment of a more extensive debt rearrangement than if the state in question had remained in the Euro.

The separation of individual states from the Euro or the disintegration of the system would not, in any way, contribute to the resolving of the current acute crisis. On the contrary, it would be the most certain way of casting Europe into a full-scale financial chaos, complete with deep depression, gigantic unemployment rates, and a radically lower living standard.

The purpose of eurobonds must be carefully re-considered

Eurobonds have been presented by many as a solution for the financing crisis of the troubled states, and the EU Commission has published a Green Paper on this matter. Up to date, eurobonds have been offered as a solution to the debt crisis at hand. The idea is that the eurozone states would jointly issue bonds for which they would be jointly liable. Each participating member state would be liable for the issued bonds in full. The bonds would increase solidarity and prevent individual states from being at the mercy of the financing markets.

Eurobonds are no solution to the debt crisis. The idea of eurobonds could, instead, be developed to serve the growth and competitiveness of the EU on the basis of mutual benefit.

In this format, eurobonds would be extremely problematic because they would make borrowing from the markets cheaper for those countries that are managing their economies poorly and more expensive for those countries that manage their economies properly. The idea that each state must commit to

responsible fiscal policies would be completely watered down. The problem, as such, has been recognized but, for the time being, no credible solution has been presented. If eurobonds are designed specifically as a means to solve the debt crisis, there is hardly any chance for their political acceptance in those countries that have been carrying out disciplined fiscal policies.

The concept of eurobonds could, however, be developed in another direction; for example, they could be used to finance major pan-European initiatives that aim at advancing the growth potential and competitive ability of the EU. Eurobonds could be devised in a project-specific manner, and in collaboration between all those EU states that would benefit from the initiative in question. Eurobonds could be targeted so that each state would bear a limited responsibility, taking into account the particular country's own economic

interest in each initiative. Thus, eurobonds would promote the development of the EU on the basis of mutual benefit. Participation in the eurobonds would also require that the participating state commit to disciplined financial policies.

Differences in competitiveness between eurozone states are a central structural problem

Once the acute crisis is resolved, it will be necessary to find solutions to the structural problems within the euro area. Throughout the existence of the Euro, the differences between various eurozone member states, in terms of competitiveness, have widened. In order to keep the eurozone integrated, the internal imbalances must be corrected. Unless the differentiation of eurozone countries can be stopped, the future will mean either continuous income transfers among them or disintegration of the euro area. Both alternatives are unsustainable.

The internal balance of the euro area requires that the weaker states be capable of improving their

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competitiveness. Competitiveness is an issue of both pay level and productivity, so it is necessary to accept the fact that, in order to achieve the set target, these countries are facing painful solutions. Correspondingly, the stronger economies within the area must endeavour to maintain a more normal wage and salary development that matches productivity, to increase domestic demand and to get rid of excessively high current account surpluses, but without compromising their own competitiveness.

The parties to the labour market have unanimously stated that the wage and salary issues shall be resolved

In the strong eurozone states, wage and salary development that is in line with productivity will support purchasing power and growth without compromising competitiveness.

by the representatives of employees and employers. The parties' right to negotiate independently is included in the Treaties of the European Union. Collective agreements that support competitiveness must be promoted through increased dialogue and in collaboration between the labour market unions and governments, not by external dictation.

The European trade union movement could play a stronger role in the wage and salary coordination efforts across Europe. Currently, pay negotiations are, almost without exception, carried out on the national level and uncoordinated with the wage and salary development in other countries. Divergent competitiveness development would require that the trade union movement, in particular, would intensify the wage and salary coordination.

A stable operating environment and consumer demand are fundamental for growth and employment

Stabilizing the financial market and overcoming uncertainty are a precondition for economic growth. Consumers and businesses have become infected by uncertainty, thus weakening the overall demand. Getting the financial market in order and decreasing uncertainty will also improve the real-economy outlooks. Households in Europe are not overly indebted; consumption is hindered by cautiousness rather than excessive loan pressures.

In the short and medium term, it is important to maintain a sufficient level of overall demand in order to generate economic growth and to secure employment. Policies aiming at cuts across all sectors simultaneously would be disastrous for economic growth. Against this background, a moderate approach is essential, also as regards the adjustment programmes outlined for countries in difficulty. Adjustment

measures that are over-dimensioned or implemented with an extremely tight schedule will only shrink the economy and cut down jobs, without offering anything in exchange. It is noteworthy that the crisis has not resulted from the voluminous size of the public sectors as such, and hence, reducing their size will not automatically offer a solution either.

It is necessary to maintain a sufficient level of overall demand by means of wage and salary policies. As concerns those countries that are cost-competitive, in particular, the wages and salaries must rise to match the growth of productivity. It is impossible for all eurozone states to improve their competitiveness in relation to each other. Such aspirations would only result in a continuing and steepening economic downslide.

All European countries must look for new sources of growth. Investments in education, research and product development are emerging as the central means to support growth at the national level. In these areas, the public sector plays a significant role. A properly functioning public sector is also a growth-supportive factor.

At the EU level, growth can be promoted by intensifying the internal market integration and external economic relations of the EU states, including trade policy. Advancing the internal market has, however, been difficult because there has not been sufficient success in harmonizing the aspects of social issues, environment and competitiveness. For example, in several working life issues, there is no minimum level regulation. While intensifying the economic internal market is essential, the other dimensions of the common market also need strengthening.

Working toward new rules of the game

Nearly all states have repeatedly failed to meet the conditions of the Stability and Growth Pact, and consequently, it has lost its credibility. New credible rules are needed to replace the SGP. It has been proposed that the EU be given more power to control the member states' budgetary policies, for example, through the economic governance package known as the Six Pack. Its contents are appropriate and, if implemented properly, it would ensure clearly more responsible fiscal policies within the euro area than have been carried out to date.

The EU Commission, European Parliament and EU Council have reached a consensus on the reform of economic governance including the following four main components:

- The Stability and Growth Pact shall be strengthened, and failure to meet its obligations shall result in financial sanctions.
- Excessive budget deficits shall be tackled by making the sanctions more rigorous and automated. The procedure concerns both budget deficits and state debts.
- The quality and administration of national budget processes shall be improved through, for example, budgetary frameworks.
- Macroeconomic imbalances and competitiveness problems shall be reviewed and corrected through member state-specific sanctions.

In the future, it is vital that all eurozone states commit to sustainable economy.

It is vital that all eurozone states commit to sustainable economy. The surveillance of the sustainability of public economies must be made more efficient, and it is necessary

to impose credible political and financial sanctions on those states that manage their economies poorly. At the same time, national budgetary processes must be developed to a level that represents their best. These aspects are all included in the Six Pack proposals.

The credibility of the No Bailout principle must be restored. From the year 2013 onwards, all new government bonds of the eurozone states shall include a collaboration clause, which is an important step in this direction. It will clarify the mechanism by which a eurozone state that finds itself in financing difficulties would be able to negotiate the rearrangement of its debts with its principal debtors so that the agreed solution would bind all debtors.

Coordination of fiscal policies should also be extended to cover tax policies in order to avoid harmful tax competition. Suitable means for consideration would be, for example, the harmonization of a corporate tax base and the setting of a minimum rate. At the European level, the use of aggressive tax competition to pursue growth must be prevented. It is not a sustainable solution if public economies that are struggling with financing problems focus on alluring businesses by reducing taxes.

Further information

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