Q&A

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Reflexions on financial Europe

One of the important pillars of the reforms proposed in your 2009 report was to couple more integrated microprudential supervision with a European set up for macroprudential policy. Do you think that we have the right framework in place for addressing systemic risk at the European level?

It is good to note that European banks have weathered the recent turbulence caused by rising interest rates without difficulty, Europe having implemented the Basel rules unlike the United States. But we have to be careful not to be too complacent because there are still headwinds: weak economic growth and increasing defaults.

In my view, there are still several weaknesses at the supervisory level:

- The macro supervision implemented to protect the world from systemic risks has been insufficient. The crisis of 2008, that of 2010 and the resurgence of inflation in the spring of 2021 were neither foreseen as they should have been nor preceded by recourse to macro-prudential supervision.
- I believe that the system we designed in 2009 (ESRB) has not lived up to expectations and that it needs to be reviewed, as I have stressed on several occasions to the Commission. In my opinion, we should have a macroprudential Council separate from the ECB, broader than the existing one, made up of academics and technicians and endowed with real independence.
- Finally, the development of non-banks in recent years continues to concern me; their role in financing the European economy has doubled since 2008. It's a highly leveraged sector that deserves to be closely monitored. Admittedly, some form of regulation - particularly in Europe - has been put in place, but the repercussions of defaults, even if only on the banking sector that supplies these non-banks with liquidity, could pose a problem.

How do you see the future of the eurozone?

I have said a lot on this subject, and you know my answer. In my view, it is problematic for a monetary union to prosper without a minimum level of economic policy coordination, which does not exist today, which undermines the future.

As Europe is not a single nation but a confederation of national states, we have to accept that the EU seeks compromises that optimize national objectives. But a monetary union can only function if a minimum of fiscal discipline is ensured by all States which has not been the case for 25 years. We have a conflicting zone fed by 20 different approaches to economic and fiscal matters. The specificity of the euro currency is that it is not an overwhelming symbol of unity but rather a permanent source of issues to negotiate for the Member States of the euro zone.

The ECB has maintained until July 2022 a questionable negative interest rate policy in real terms, which made public deficits easily financeable: it has reduced the financial difficulties caused by the emergence of spreads. Yet, such an accommodating monetary policy has encouraged general indebtedness and financial instability. It has disincentivized Member States to undertake necessary structural reforms (especially in France and Italy). Overall, this has been accompanied by a decline of growth and of corporate competitiveness in over-indebted countries.

The current intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a current policy of "every man for himself", creates a climate of mistrust between Member States which hinders progress in terms of public and private risk sharking and weakens the eurozone.

This overview is not optimistic.

If fiscal, inflationary and economic drift continues in the eurozone, the "virtuous" countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is to be the case, the logical outcome could well be a new and inevitable eurozone crisis.

What do you think of the compromise reached by the Ecofin Council in December on the revision of the Stability and Growth Pact?

Public debt levels are at records and fiscal deficits remain way too large in large EU member States (France, Italy, Spain in particular). The fact that money has been thrown at the problems for years has worked against supply-side policy which are essential to raise potential growth, and which have been the orphans of the EMU story.

On 21 December 2023 the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament on the preventive arm regulation.

Although the case-by-case framework – which is a specific technical dialogue between the EU Commission and each member State regarding their differentiated multi-year budget trajectory - has been introduced, which is positive, the goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies.

There are several areas of concern:

- Countries that are subject to an excessive deficit procedure (total public deficit over 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. These countries will only be subject to the procedure once their public deficit has fallen back below the 3%. This is not the best way to encourage the worst performers to reduce their debt to GDP ratio! It's as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.

  The quality of public spending and composition on public finances must be given more importance than its quantity. But if countries that are subject to an excessive deficit procedure are not required to reduce their public debt by an average of 1% a year, they will have no incentive to do so. This is an incentive to remain above a 3% deficit for as long as possible. When the level of public debt is at the limit of what can be tolerated, the trade-off in public spending is generally in favour of the most current and unproductive expenditure in order to cope with the next day, instead of giving priority to research, training and well-chosen public infrastructure investment.

- Adjustment implementation horizons seem very long: 4 to 7 years to reduce the public deficit below 3% (the annual adjustment of the structural primary deficit must be 0.5%). Such horizons also extend beyond typical political cycles, and experts deem the Commission unlikely to force a government elected with different priorities in the middle of the seven-year cycle to implement policies agreed by its predecessor.

How do you explain this lack of ambition in the reform of the Pact?

The postponement of the of budgetary adjustment for countries subject to an excessive deficit procedure is based on two erroneous prejudices:

- The reduction in the public debt ratio is based on a return to very low medium and long-term interest rates, which is likely to prevent budgetary efforts (i.e. cuts in public spending). This is the "easy money" paradigm: an accommodating monetary policy (permanently low interest rates) avoids budgetary efforts.

- Any budgetary adjustment is "by nature" recessionary because economic growth is based primarily on domestic demand.

These two assumptions should lead European countries with excessive debt to continue their economic decline. There are several explanations:

- Recent monetary history (2014-2021) puts the emphasis on the paradigm of easy money which leads to excessive debt that does not stimulate economic growth. Persistent low (or even negative) interest rates over this period have not led to an increase in productive investment but has on the contrary encouraged savers to keep their financial assets in liquid instruments (see Eurofi Scoreboards) and not to channel them in securities geared to long-term investments[1]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (e.g. development of zombie firms).

Given the headwinds we face, it would be very unwise to cut interest rates too soon and give in to the desire of the markets. It would be prudent not to rule out the possibility of high interest rates for longer than we think.

- Excessive deficits and debt jeopardize economic growth. They require an increasing tax pressure, which deteriorates further the competitiveness of companies in these countries. Stimulating demand does not translate into increased production but leads to a widening of trade deficit if a country does not have an efficient production system. On the contrary, what is needed to increase potential growth and achieve a better allocation of resources is:

  - To return to primary surpluses as soon as possible,
  - To rationalize of public spending – qualitative public spending must be an absolute priority – in countries where the public spending-to-GDP ratio exceeds the European average,
  - To steer supply side-oriented reforms that enhance productivity gains.

1. *Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.*