



ICC KEY MESSAGES ON THE EUROZONE CRISIS

- When the inaugural meeting of ICC's Group on Economic Policy was held on 27 June 2012, Europe's single currency seemed on the point of disintegrating as sovereign borrowing costs in Greece, Spain and Italy soared to dangerous levels. Speculation was rife that the eurozone was headed towards a break-up, with incalculable financial and political consequences. The perception was widespread that governments in Europe were disunited and half-hearted in their response to the crisis and were unwilling to take measures on a scale that might hold the eurozone together.
- The previous day, however, a glimpse of hope had emerged with the presentation to the European Council by the Council President of a Report entitled "Towards a Genuine Economic and Monetary Union". The stated aim of the Report was to set out a vision for the future of economic and monetary union in Europe with proposals for a stronger architecture based on integrated frameworks for the financial sector, for budgetary matters, and for economic policy. It was not meant to be a final blueprint, and further work was foreseen to "develop a specific and time-bound roadmap for the achievement of a genuine economic and monetary union".
- One month later, when it seemed almost too late, the European Central Bank (ECB) began belatedly to measure up to the scale of the crisis threatening the eurozone when its President, Mario Draghi, in effect dared the financial markets to challenge the ECB's unlimited firepower with his now-famous declaration: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough". The impact of those two short sentences was immediate and substantial. The ECB followed up in September 2012 by announcing its 'outright monetary transactions' (OMT) programme, promising to buy unlimited quantities of bonds with a maturity of less than three years of any country with a distressed debt market, conditional on the country applying to the European Stability Mechanism for assistance and agreeing to certain fiscal criteria. Mr. Draghi's July declaration and the OMT programme have proved extraordinarily effective to date in changing market sentiment. Even though none of the debtor countries has so far applied for the programme, there has been a considerable fall in the cost of new borrowing by peripheral member states in Europe and a renewal of confidence in the survival prospects of the eurozone and its single currency. The reaction suggests that the ECB has strong credibility as well as huge firepower; the markets both trust and fear the ECB which, after a hesitant start, appears now to be doing its job properly in helping to combat the crisis in the eurozone.
- By mid-January 2013, the yield on Spanish and Italian 10-year government bonds was about 2.5 percentage points lower than six months earlier. Spreads between the yields on Spanish and Italian bonds and German Bunds had fallen from 6.4 to 3.4 and from 5.3 to 2.6 percentage points respectively. Though still dwarfed by the huge net outflows in previous years, recent months have seen almost €100 billion of net private inflows back into the periphery. Eurozone banks – including in the periphery – are repaying early €137 billion of loans from the ECB under its long-term refinancing operation. Corporate bond issuance in the eurozone has returned to levels last seen before the region's crisis broke in late-2009. And the trade-weighted exchange rate of the euro has in recent months maintained a resilience that suggests a growing belief that the single currency will survive after all. In January 2013, Mr. Draghi spoke of "positive contagion, when things go well".



- ICC emphasizes how important financial stability is for the eurozone. It acknowledges the recent, much-needed improvement in policy-making in the region – and especially the greater policy flexibility shown in the face of prolonged recessionary conditions and grave economic hardship in several periphery countries. ICC particularly applauds the leadership of the ECB.
- While greater financial stability and the return of private capital to the eurozone periphery have raised confidence from its lows of last year, the underlying picture for the eurozone remains grim. The IMF is forecasting more negative growth for the eurozone in 2013; the recession is deep in the periphery and unemployment is very high and rising, stoking fears of social unrest. Fiscal positions are improving in Spain and Italy but at a slower pace than expected, given that fiscal multipliers are turning out to be much higher than predicted. Small firms are suffering from a drought in bank finance or higher loan interest rates as a consequence of the necessary improvement in banks' capital and liquidity ratios, combined with supervisory and Basel III measures; and problems remain in the financial sector. Without economic growth, deficits will be harder to correct, indebtedness will grow, and banks will remain vulnerable. A further big concern now is that the sharp fall in bond yields in the eurozone periphery may blunt the incentive for eurozone policy-makers to take tough decisions to restructure their economies and re-design the eurozone.
- ICC has been very critical of the decade of cheap money, high leveraging, easy credit, and associated asset bubbles which were at the root of the near collapse of the world's financial system in 2008 – to which lax fiscal and regulatory policies also made a major contribution. Though the roots of the initial credit crisis lay in the US, the financial crisis has been particularly severe and prolonged in Europe because of a) the large role of banks in the financial intermediation process in Europe compared to the US, and b) the existence of a flawed European monetary union that exacerbated a boom in capital flows and credit and complicated the correction process as boom turned to bust. The early years of the euro saw a lot of imprudent lending and borrowing and regulatory failures in the deficit countries (as elsewhere). But the grave problems those countries face at the present time were not caused by themselves in isolation. They were part of a defective monetary union which encouraged both reckless borrowing (in the deficit countries) and reckless lending (in the surplus countries) and in which members states no longer had national central banks with lender of last resort powers nor the flexible option of national monetary and exchange rate policies.
- ICC believes it is right that all countries that were responsible for the faulty design and operation of the eurozone system should accept some burden-sharing to help those member countries that are today paying an exceptionally painful price for the eurozone boom years in terms of austerity, recession, and unemployment. These so-called 'legacy costs' should be addressed by policy-makers as a separate issue from the re-design of the eurozone system. Solving the 'legacy problem' requires significant burden-sharing in the form of official support to reverse the decline of output and employment in deficit countries, lower their debt, and reduce current account imbalances within the currency union. However, it does not follow that rectifying flaws in the eurozone system demands *permanent* transfers or jointly and severally issued debt, which would need a change in the Treaties.
- While fiscal adjustment programmes are important in restoring the economic credibility of deficit countries, it is in nobody's interest if such programmes are so drastic and short-term oriented that their principal effects are to sharply depress output and *increase* deficits and indebtedness. Debt built up over long years of boom cannot be unwound overnight – and neither can the large cumulative divergences in competitiveness among eurozone countries. A sense of no end in sight in many deficit countries is undermining support for vital fiscal and structural reform programmes and may lead to political instability. At the same time, surplus countries are understandably concerned to ensure that, in return for continued support, pressure is maintained on deficit countries to persevere with fiscal and structural reform in order to raise their growth potential.

- The EU's 'fiscal compact' of March 2012 was an important step towards the enforcement and credibility of EU fiscal rules by anchoring them in national legislation. Within that framework, it should be feasible for eurozone policy-makers to devise support arrangements that allow for the easing of fiscal austerity in countries that are stuck in prolonged recession provided they continue to pursue sound structural adjustment programmes and commit themselves to credible timetables for reducing indebtedness over the longer term. The structural reforms should aim at restoring solvency and improving competitiveness while limiting negative impacts on output – such as raising the retirement age, increasing the efficiency of labour markets, trimming bloated public administrations, and replacing some payroll taxes with indirect taxes.
- As for re-designing the eurozone, there seems to be widespread agreement from the lessons of experience that it has three principal faults. First, unifying eurozone monetary policy at the supranational level while leaving fiscal policy and banking supervision at the national level creates distortions that encourage excessive borrowing and lending, both public and private. Membership in a currency union implies automatic access to official balance of payments financing. At the same time, by inducing closer economic and financial linkages among member countries, currency unions amplify the impact on others of national crises – and especially banking crises. Secondly, ceding national control over the money supply exposes members of a currency union to 'rollover crises' in financing public debt. Without access to the printing press in an emergency, the result can be a self-fulfilling fiscal crisis. And, thirdly, giving up the option of national exchange rate adjustment exposes members of the union to the painful process of 'internal devaluation' to correct losses in competitiveness.
- This diagnosis argues for: more centralised co-ordination of fiscal policy to counter the impact of a one-size-fits-all monetary policy; a banking union with eurozone-level banking supervision and a single resolution authority for all banks; and a eurozone-level lender of last resort for governments that respect the fiscal compact.
- ICC acknowledges that, after a dangerously long period of drift and half-measures, policy-makers have more recently taken steps that have signalled a more credible political will to preserve the eurozone intact. Decisive action by the ECB has calmed the bond markets for the time being, but that could go into reverse on more bad news. And there is still plenty of bad news around. Economic output is either flat or declining throughout the eurozone. The crisis in the currency union is still far from over, as evidenced by the outcomes of the Italian elections in February and the Cyprus "bail-in" a few weeks later. The governance of the eurozone has been changing from the traditional community system by which the European Commission proposes and the European Council disposes to an intergovernmental system in which the Council proposes and disposes and the Commission helps to execute. The Cyprus deal demonstrates the shortcomings of the new intergovernmental system. For the first time, albeit temporarily, it has allowed Cyprus to avoid complying with article 63 of the European Treaties which prohibits all capital restrictions among member states. It has introduced a new bail-in doctrine for the future by which those who hold deposits above €100.000 know that, if their country gets into financial trouble and has to ask for support from other eurozone members, they are likely to lose part or all of their savings. These decisions may increase systemic risk in the eurozone and may make future banking crises more likely and deeper.
- The eurozone governments need to commit themselves with urgency, unity and determination to a coherent and credible strategy for reforming the eurozone and making advances on the roadmap towards a fiscal and political union - not only to reassure the markets but also to offer hope to millions of European citizens and businesses in deficit countries that the considerable hardship they are suffering is serving a useful purpose in laying the foundations for a more prosperous and secure future.