Europe Struggles to Get Ahead of the Curve

Nicolas Véron says that steps by errant countries and European leaders to stabilize the euro have eased the sovereign debt crisis, but the lull may be temporary.

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Steve Weisman: The sovereign debt crisis in Europe led to predictions that the eurozone and the European Union would split apart and be unable to cooperate. But according to Nicolas Véron, visiting fellow here at the Peterson Institute, the trend toward more cooperation has gained steam. This is Steve Weisman at the Institute. Thank you, Nicolas, for being here to talk about that.

Nicolas Véron: Thanks to you, for having me.

Steve Weisman: How is the European Union cooperating?

Nicolas Véron: I think at this point optimism has to be very guarded and cautious. We don't have the [knowledge] of the debate behind the scenes or what could even be the date at which a deal will be announced, which is of course extremely sensitive from the marketplace perspective. It has shifted a bit. Now it's said to be in late March.

Steve Weisman: Of course there have been other deals that have worked only temporarily.

Nicolas Véron: Exactly. There is a secure acknowledgement by European leaders that they have been behind the curve in most of the prior episodes and they want to get ahead of the curve. But that doesn't mean that they will manage it. I think, however, that they have learned some lessons, perhaps not all the lessons from the episodes in 2010, and especially the degree to not reach crisis.

Steve Weisman: What do we know, even though this process is not finished?

Nicolas Véron: There are two things that are very actively discussed these days. One is what exactly a supernational debt management and debt issuance facility will look like. And what it can do both in the short term with the current European financial stability facility (which is now up and running in Luxemburg and has very successfully issued a first batch of debt) and in the medium term with the establishment of a permanent mechanism, which is now called the European Stabilization Mechanism. And that could have different features.

So that is the first set of questions. What can the eurobond issuers—actually I shouldn't use this term because eurobond would mean something more supernationally integrated than what is currently considered (but that is very much how the market sees it). How should this eurobond issuer be structured? What should its mandate and tools be? For example, should it be able to buy sovereign bonds?

The second set of issues: what sort of coordination is going to make policies in the broader sense that we had in the euro. Are we to avoid the sort of imbalances that we have seen materializing in 2010 happening again in the future? So there are ideas floating—for example, raising pension retirement age throughout the euro area, having a common corporate tax base and perhaps even harmonization of corporate tax rates, and some proposals for economic policy coordination or harmonization that are more radical than anything that has been discussed in Europe so far. This would apply to the euro arena, the 17 members of the euro area. At this point it is too early to know which member state says what on each of these proposals, which are very much up in the air.

Steve Weisman: I've read in some news accounts that the steps that you just mentioned on coordinating pensions is significant because the Germans have come around to the French point of view. Is that an oversimplification?

Nicolas Véron: It is an oversimplification, especially on the part of pension, because pension is precisely one of the issues the French might not agree with. The French have traditionally said, we need more economic coordination in euro arena. We need the economic government of the euro area, gouvernement economique, which has been the slogan. But it always has been unclear exactly what the French were putting forward. So now we are getting concrete. You mentioned the pension discussions. Nicolas Sarkozy raised the retirement age from 60 to 62 last year, and this was very controversial in France. He really had to push it to get the larger parts of the French public. So raising this to 67, which is a German number, would be very painful politically. We are still at the beginning of discussion of what economy policy coordination and economy governance in the euro area might mean in practice.

Steve Weisman: But the Economic Stability and Growth pact, which was supposed to govern deficits, was a failure. Why would these coordinated steps succeed?

Nicolas Véron: That is right. Everybody has a failure, or what was largely the failure in mind. And I think in a way there is an even larger question. It is alright to think of what they should do in terms of economic policy in theory, but in practice all of this is politics. And the political institutions at this point don't support this unity of purpose that they are trying to hardwire into the economy policy mechanism. I think this gap between the political framework and the chance to reform the economy framework—the economy policy framework—is going to be more and more visible. So we will have pledges, promises, which may not be credible. Even attempts to hardwire the discipline into the institutional framework may not be fully credible. For example, the Germans are pushing this idea of dead breaks—which is this idea where you have limits to the national debt enshrined in the constitutional arrangements or in a very hard legal way that makes it impossible to go beyond a certain level of debt. And certain countries have adopted this.

Steve Weisman: Why not let the markets determine that?

Nicolas Véron: Well, because the Germans say the market basically has failed and that is right. The market has failed to impose discipline on countries like Greece for decades. And it has certainly woken up in 2009, early 2010, but the market disciplines didn't work in cases such as Greece or Ireland. So basically the Germans' idea is to enshrine it in constitution terms. The Germans have done that, Poland has done that, a number of countries have done it, so let's do it throughout the euro area.

Even this may actually not be credible enough. One example is Hungary. Hungary has introduced a fiscal council, the sort of fiscal institution that Germany calls for, but you know they just got a new government last year with a very large political majority and very strong public rhetoric, and they just got rid of the fiscal council. So even if you have it enshrined in the legal basis of your political institution, that doesn't mean that it is here forever. And the Hungarian majority has modified the constitution of Hungary several times.

So I think we really are at the very, very early stages of this learning curve of the concepts currently being floated in terms of the economy being coordinated from the political standpoint and from the institutional standpoint. At this point we are in totally uncharted territory.

Steve Weisman: The next big question is about fiscal transfers between the wealthy successful countries in Europe and the ailing countries on the periphery. Could we move towards such a concept through the back door, if there is also going to be fiscal coordination enshrined in the constitutions or in law?

Nicolas Véron: It's a whole debate on fiscal federalism. This is a very slippery concept because it means different things to different people. Jean Claude Trichet [president of the European Central Bank] has called for budgetary federalism particularly because in France budgetary fiscal means very different things to us, depending on the translation of fiscal federalism.

But if you understand fiscal federalism in the broad sense—which is basically something that is more supernational than fiscal sovereignty at the national level in the framework we have in the euro area—we already have it. The European Central Bank's collateral policy, in which it accepts collateral on behalf of the entire euro system, is fiscal federalism. It is in the Maastricht Treaty. It is perhaps a sort of very invisible and indirect form of fiscal federalism, but that is it.

Steve Weisman: Explain.

Nicolas Véron: Because if the European Central Bank accepts collateral from banks, with a fairly flexible policy of collateral recognition or standards, that means it can make up losses on this, and it makes up losses, that is in fact a guarantee by all area member states. It will increase the capital to cover the losses. And the European Central Bank has asked the members states to increase the capital by a couple of billion euros this year. That is not purely fiction. It means that taxpayer money is being used for a common goal, which is to me the definition of fiscal federalism. Not that taxpayer's money is actually used, but the mechanism implies that it may be used in a way that is binding on the member states. So any common bond issuance in this view is fiscal federalism with a common joint guarantee is fiscal federalism. If you look at it that way I think it is fair to say that we already have it. I mean if the EFSF (European Financial Stabilization Facility) is individually guaranteed by each member state and it is not a joint and several currency on paper. But what does that mean in practice? If the EFSF guarantees the EFSF bonds, how would it play out? My sense is that the market perception is that it is in fact a guarantee to members, if you accept this view. The question is not, should we practice federalism in Europe?; it is, since we already have it, how do we organize it?

Steve Weisman: When do we get to the next potential step, which is use of taxpayer's money to shore up banks if they take losses on Greek or other debt if that is restructured?

Nicolas Véron: At this point, and I expect this to stay the case certainly this year and in the short term, this is channeled by the member states. In a way it's a smoke screen. Because what is happening right now is that, if there is a big banking problem, the member states will intervene with national taxpayer's money. But the members say that if it does hit sovereign debt, they will call the European Financial Stabilization Facility for loans from the entire euro area. So basically you do have the fact of financial intervention of fellow euro area members on the banking system, but channeled by the member states because this is considered more politically acceptable.

Does it make a huge difference in practice? You can debate it. At this point the banking risk and the sovereign risk in those countries that are fragile like Greece and others—is very, very difficult to untangle. We saw that very clearly in the Irish projects. Basically, the ECB (European Central Bank) especially and the IMF (International Monetary Fund) in the end imposed a framework on how to shore up the banking system on the Irish government as a condition for the loan to the Irish government. And this is very typical of this interconnectiveness to the point of total convergence of a banking situation and the sovereign situation.

Steve Weisman: Final question. In December there was a lot of panic in the markets about the debt of these peripheral countries, including Spain. Have things stabilized? If so, why?

Nicolas Véron: They have stabilized from a market perspective. This is clear and actually very significant. The market's concerns late last year, when countries were becoming concerned about Portugal, Spain, and the others. And euro area concerns about the incompleteness of the policy (if you want to call it that). And the combination was explosive. Since then, two things have happened. Euro area members, especially Germany, have signaled that they wanted to get ahead of the curve and discuss the more compelling policy framework. And this is a discussion that's currently underway that will possibly lead to a decision in March. And Portugal and especially Spain have been taking vigorous measures to sort of fix the situation and make the threat of market disruption less immediate. Spain is especially taking very courageous measures to shore up its banking system and its savings banks, which are a large part of the current market perception of risk. So both these things are temporary. Pressure could come back to some countries, perhaps Portugal or Spain or perhaps others. We are not sure that the euro area member states will come up with an agreement on something that will satisfy the marketplace, that the euro area now has at least for a short term, it has a good policy framework. But at least at this point, these two elements have certainly calmed the most immediate fears.

Steve Weisman: Nicolas, thank you.

Nicolas Véron: Thank you very much