

Pierre Cailleteau, The Eurozone Crisis: The Beginning of the End, or the End of the Beginning

The Allied victory at the Second Battle of El Alamein in November 1942 marked a major turning point in the campaign against the Axis forces in WWII. When informed of the victory, in true Churchillian style, the British Prime Minister commented, "Now this is not the end. It is not even the beginning of the end, but it is, perhaps, the end of the beginning". Our speaker for this week, Mr Pierre Cailleteau of Lazard International, began his talk last Tuesday evening by suggesting that the same could be said of the current situation in the eurozone. However, according to Cailleteau, it's more a question of political capital, than economic know-how that, up until now, has prevented that end from being reached sooner rather than later.

In September of last year, the President of the European Central Bank, Mario Draghi, announced the organisation's plans to engage in outright monetary transactions, or OMTs. OMTs involve the outright purchasing (by the ECB) of sovereign bonds with a maturity of between one and three years. The benefits of such purchases are twofold. Firstly, the ease at which nations can borrow money is instantly increased and secondly, as the demand for bonds rises their yields fall and countries can therefore also borrow more cheaply. The Bank only undertakes such purchases if the country has previously applied to the European Financial Stability Facility or the European Stability Mechanism for assistance and are subject to the country agreeing to stringent financial monitoring by the European Financial Authorities and the IMF. Immediately after Mario Draghi's announcement, the borrowing costs for all major European sovereigns fell significantly.

Cailleteau believes this to be exactly what the doctor ordered and argues that the risk of imminent dislocation within the eurozone has now receded. The benefits of the policy itself aside, it also suggests that the political will to take whatever measures are necessary to stem the crisis may be increasing, and that the days of teetering back and forth by Europe's leaders may be coming to an end.

As part of the wider plan announced alongside the OMT, the ECB and other financial authorities will be putting in place the measures that will allow for the disintegration of floundering financial institutions. According to Cailleteau, this is long overdue and the example of the US, in which a number of banks are dissolved on a weekly basis, should have been followed long ago. This necessarily involves guarantees for depositors he argues, but he does not share the same sympathy for private investors – his message for them simply being: 'too bad, you didn't do your homework'.

So when will we know that the worst's behind us, and that we're back to something like 'normal'? That, argues Cailleteau, is entirely dependant on how we choose to define what normal is; if we opt to view normality as the economic environment at the beginning of the 21st century, then it's a while away yet. The period of economic prosperity that ensued after the millennium was built upon the unsustainable foundations of leverage and the overextension or economic

agents argues Cailleteau. He believes that normality into the future is going to involve all stakeholder groups within the economy, whether they be consumers, firms or the government, shrinking their balance sheets and entrenching their finances.

Cailleteau argues a number of changes are necessary before we can claim to have returned the economy to something like a sustainable growth path. Firstly, we must have a banking sector that acts in the interests of society, whilst generating an acceptable margin of intermediation: 'we need to make banking boring again' he remarked. Secondly, the necessary deleveraging of the financial sector must be undertaken in such a way that the economy is not suffocated as a result – Cailleteau views this synchronised deleveraging of economic agents as being the most important policy change of recent times.

There must also be a convergence in terms of the value of the euro across members of the common currency area. Citing the divergence in interest rates between towns that border each other in Austria and Italy, Cailleteau argues that such practices cannot continue if confidence and stability are ever to return. Of relation to this is the need for sovereigns to be able to borrow at interest rates that are lower than the rate of nominal GDP growth.

Cailleteau believes that, in terms of how the eurozone will be viewed in years to come, there are two possible outcomes. The first is that member states undergo substantial structural reform (something that would never have been necessary without the common currency) and, as a result, prevent the decline of old Europe and see in a new period of, albeit more restrained, prosperity. Or secondly, that the problems currently facing the common currency area will not be overcome and that the European experiment will be viewed as the endpoint of a technocratic project that hit the wall of political legitimacy.

Personally, I believe that the announcement of OMT suggests that the former is the more likely of the two outcomes. Europe's political leaders, having backed the euro in the first place, have their reputations on the line and understand that their own fates are, to a certain extent, tied to that of the monetary union. Whilst the thought of bank rolling Greece and other ailing European states may leave a sour taste in the mouth of Angela Merkel and co., the political and economic implications that would ensue were the EU to be disbanded would be of much greater cause for concern. The same can be said about the destabilisation that would occur were members to begin to exit the currency area.

The American Film Director Woody Allen once wrote: 'More than at any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly.' The decision of Mario Draghi and the ECB was a step in right direction. For the sake of the eurozone and the global economy as a whole, we can only hope that Europe's policy makers continue to take such steps into the future and give Mr Cailleteau and his former colleagues at the ratings agencies continued reason to be increasingly optimistic.