Riding through the storm

Marco Buti draws the main lessons out of five key moments in the euro crisis for the completion of EMU and the appropriate policy mix in the euro area

On 1 December 2019, after eleven years, I left the position of Director General of Economic and Financial Affairs at the European Commission. I have tried to encapsulate both a sense of this journey through the euro crisis as well as my policy conclusions in a CEPR Policy Insight by focusing on selected past episodes, some well-known, others less prominent (Buti 2020).

The 'moments' I've chosen are the following:

- Latvia, one of the 'Baltic Tigers', asking for financial assistance in November 2008, which could be seen as a prequel of the crisis in the euro area, with the sudden stops after the build-up of large imbalances and deep-rooted bank vulnerabilities.

- The G20 Meeting in Toronto in June 2010 where policy authorities (though with different degree of enthusiasm) 'declared victory' over the financial crisis and decided to start withdrawing the fiscal stimulus with a commitment to halve their deficit by 2013 and stabilising the debt ratios – a decision which in retrospect proved largely premature and economically very painful.

- The Deauville meeting in October 2010 between the then French President, Nicolas Sarkozy, and the German Chancellor, Angela Merkel, where a decision was made to bail in sovereign bond holders, which is widely accepted as having been pivotal for the euro area crisis.

- Mario Draghi's speech at Jackson Hole in August 2014 which started to change the narrative on euro area policy mix, with a call for fiscal stimulus and structural reforms to be deployed side by side with monetary expansion.

- As an ‘extended moment’, the developments in Greece, starting in 2010 with a dramatic revision of the Greek fiscal accounts, subsequent loss of market access and the need for the EU and the IMF to intervene in the context of a generalised loss of trust, culminating with the ‘Grexit’ debate in summer 2015 and Greece successfully exiting the programme in August 2018.

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A reading across these episodes and the ensued policy responses lead me to draw eight lessons for European policy coordination and governance:

- **The way in which the crisis unfolded tainted the narrative on its nature. Because of Greece's fiscal crisis, we also viewed the other countries through 'fiscal lenses', which I believe to have been a mistake.** For instance, if Ireland had come to fall before Greece, perhaps different causes for the crisis would have been diagnosed for all programme countries, events would have unfolded quite differently, and we would probably be telling an altogether different story today.

  While Greece caused our diagnoses to be incomplete, we moreover also did not recognise at the time that the prior events in the Baltics were relevant for the euro area. The Baltic crisis in 2008 could have been used to inform programmes for struggling euro area countries and to prioritise adequate policy responses and reforms. Instead, they were perceived as unrelated developments.

  With the main focus on fiscal retrenchment, financial sector reform and recapitalisation of banks did not receive adequate priority at first. The proposal for creating Banking Union had to wait for the sovereign debt crisis and was only put forward in June 2012.

- **Financial crises even in small countries can have pervasive effects and a high potential for contagion.** This contagion risk was not perceived at the time. The crisis in the Baltics was seen as potentially having spillovers effect in the rest of Eastern Europe, but the thinking was that individual IMF-EU programmes would suffice to tackle it. Similarly, as we learned painfully in the case of Greece, a crisis in a relatively small corner of the euro area could have lethal effects in the context of an incomplete currency union, lacking appropriate lending of last resort and risk sharing mechanisms.

- **Financial markets operate according to 'horizontal and vertical lines'.** Financial markets do not exert gradual pressure on borrowers, or, in other words, market sentiment change rapidly from benign neglect to extremes.

  As the Deauville episode shows, it is a daring undertaking to rely on markets to discipline countries. The non-linear behaviour of markets is heightened by exclusive focus on risk reduction, which, if not coupled with risk-sharing measures, can actually increase risk. At the same time, as market sentiment can change quickly, any fiscal misbehaviour can be punished harshly.

  This is a warning to high debt countries on the need to keep their debt credibly on a downward trajectory. Even wrong messages tailored to domestic political constituencies can lead to dear consequences – as Keynes famously quipped, *"markets can stay irrational longer than you can stay solvent".*

- **A certain amount of risk sharing is needed in EMU: either via national budgets or via the ECB balance sheet.** In order to function properly – as with any currency union – EMU requires a certain amount of risk sharing. This can either be accomplished directly via fiscal risk sharing (via the national budgets, a euro area central fiscal capacity or a common safe asset) or – in a less transparent way – via the balance sheet of the ECB. The euro area chose the latter. The limits of this choice, however, are evident today as the ECB has become overburdened in fulfilling its mandate.

- **Monetary policy cannot be the only game in town.** There is a growing consensus that today, with monetary policy facing increasing constraints, a more active role of fiscal policy, in particular by countries with fiscal space, is needed. Experience also shows that, in the aftermath of deep crises, early withdrawal of fiscal support can be very damaging and lead to an unbalanced policy mix.

The logic of Sargent and Wallace's (1981) *"unpleasant monetary arithmetic"* is that unless countries conduct prudent fiscal policy, the independence of monetary policy can be called into question via pressure for monetising the debt. However, paradoxically, excessive fiscal prudence may also be a form of fiscal dominance: when monetary policy is at the effective lower bound, fiscal inaction hampers the effort of the central bank to fulfil its mandate. Hence, in today's world, Sargent and Wallace's argument is turned on its head.

- **Achieving an appropriate euro area fiscal stance only via horizontal coordination of national policies is exceedingly difficult.** Over the past several years, it has proven politically impossible to attain an adequate fiscal stance for the euro area as a whole via bottom-up coordination.

  When a broadly acceptable overall stance was achieved, that took place via the wrong distribution between countries, in violation of their respective fiscal space. This was not fully recognised during the crisis, but since then, the issue has received more attention.

  A central European fiscal capacity complementing the national budgetary policies is needed to achieve the required fiscal stance for the euro area and, if well designed, also help to better enforce the common fiscal rules at country level.

- **EU-level decisions should be insulated as much as possible from domestic political economy considerations.** It has proven very difficult to make the swift decisions and stick to them even on matters with potentially high relevance for market sentiment and financial stability. More generally, processing policy decisions only through 'moral hazard lenses' may not lead to sound policies.

Whilst providing the right incentives for policymaking is essential, moral hazard considerations have to be tempered by the need for urgent policy responses. This is particularly true in times of economic and financial stress, for instance as was the case in Greece, or in the sovereign debt crisis in the euro area in 2011-12.

- **Programme work exposes to political risks.** The Commission paid a hefty political price for running the rescue programmes together with the IMF and ECB. It was criticised from both sides of the spectrum: on the one hand, it was perceived as being an agent of the creditors and enforcer of austerity in vulnerable countries; on the other hand, the Commission was also unpopular among governments and the public in countries like Germany, where it was perceived as being too lenient.

  These perceptions were unfortunate, since the Commission's North Star has always been the common interest of Europe and its citizens. The decisive role of the Commission in averting Grexit is a case in point. The larger responsibilities in crisis management attributed to the ESM will in the future help dispel the perception of the Commission as the 'agent' of the Eurogroup.

I believe the above lessons have important implications for the next steps in the completion of the EMU architecture. They should also lead us to reflect on a better policy mix to ensure balanced and sustainable growth.

As to the architecture of EMU, we need to do the following:

- **Complete the Banking Union.** A crucial insight guiding the design of the Banking Union has been that risk reduction requires risk sharing, and the latter should be seen as insurance, not as a one-way street.

- S**et up a European fiscal stabilisation capacity.** While an appropriate fiscal stance is needed to achieve a balanced policy mix, it has become increasingly clear that achieving it solely via national coordination is very difficult, underscoring the usefulness of a central fiscal capacity (Buti and Carnot 2018).

- **Increase the democratic accountability of European integration.** As argued in Buti and Krobath (2019), a move from the intergovernmental method, which gained ground during the crisis, back towards the community method would improve both efficiency and accountability.

- **Strengthen the international role of the euro.** A fundamental condition for that is completing the EMU, also in terms of governance, including addressing the relative scarcity of euro denominated safe assets (Acedo Montoya and Buti 2019).

The current slowdown and lacklustre medium-term growth prospects also indicate that the fiscal, monetary and structural policy mix needs to be changed. As Mario Draghi stated in his speech in Sintra (2019), monetary policy needs to remain patient, persistent and prudent. Fiscal policy needs to fulfil the three Ts as identified first by Larry Summers (2008): timely to be effective, targeted by focusing on high multipliers expenditure and – possibly – temporary.

While the jury is still out on the desirable fiscal trajectory in presence of ultra-low interest rates, there is little doubt that a long-lasting boost of public investment should be undertaken. One such example would be quality-investment to ease the environmental transition.

Complementing Draghi's three Ps for monetary policy and the three Ts from Summers, I propose three Fs for structural reforms: they should be feasible to be effective in the short term instead of aiming for unrealistic goals;

forward-looking, for instance regarding environmental issues; and fair, by incorporating distributional concerns and moving away from the perception of reforms as 'blood and tears'.

Joining the letters, they spell TFP, a fitting acronym to capture today's economic and policy predicament in Europe. ■

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