Crisis and cooperative solutions: the euro area since 2008

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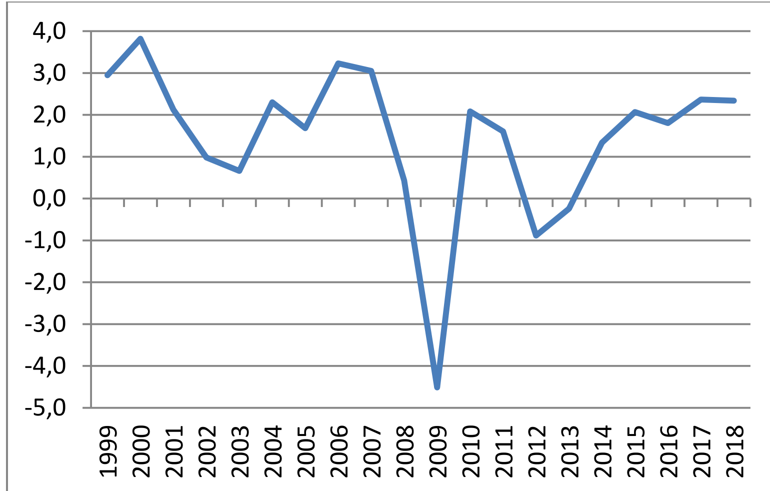
Abstract:
Since the European integration process began, the European Union has always moved forward in fits and starts, from one crisis to the next. But, the most-recent crisis showed up fault lines in its economic governance.
The euro area was seriously affected by the US banking crisis which started in September 2008. The first phase of recession, which became global in 2009, led to a second European stage in 2012-2013. This followed on from the coordinated rollout of fiscal austerity policies. The failure of European fiscal governance to stem the crisis then forced the European Central Bank (ECB) to introduce extraordinary measures.
As a result, the cornerstones for coordinated management of economic crises were laid with the setting up of the European Stability Mechanism (ESM). Alongside this innovation, reform is still required to ensure better interaction between monetary and fiscal policies, and with structural reforms in Europe.

A decade on from the start of the global financial crisis, the euro area has returned to its pre-crisis average annual growth rate of just over 2%. The economic recovery is characterised by lower unemployment, price stability and a robust current account surplus. Whilst the economic situation has improved dramatically since 2015 (chart 1), the path to recovery remains strewn with hurdles, and European economic policy coordination is not the least of these.

The crisis brought to light the shortcomings affecting the coordination of fiscal policies and this contributed to pushing the euro area into another recession in 2012-2013. With the current institutional state-of-play, these shortcomings are still present. In fact, they partly spurred the unprecedented response of the ECB that highlighted the insufficient coordination between monetary policy and the fiscal policies of the Member States. Monetary policy has also tested the concept of the lack of financial risk-sharing between Member States. The euro area's unresolved dilemma between market discipline and institutional solidarity, despite the setting up of the ESM, has ultimately delayed macro-economic stabilisation policies and is also holding up the completion of banking union.

English version: Translation Centre of the French economy and finance ministries

Chart 1. Trend GDP in the euro area, at constant prices, in %.



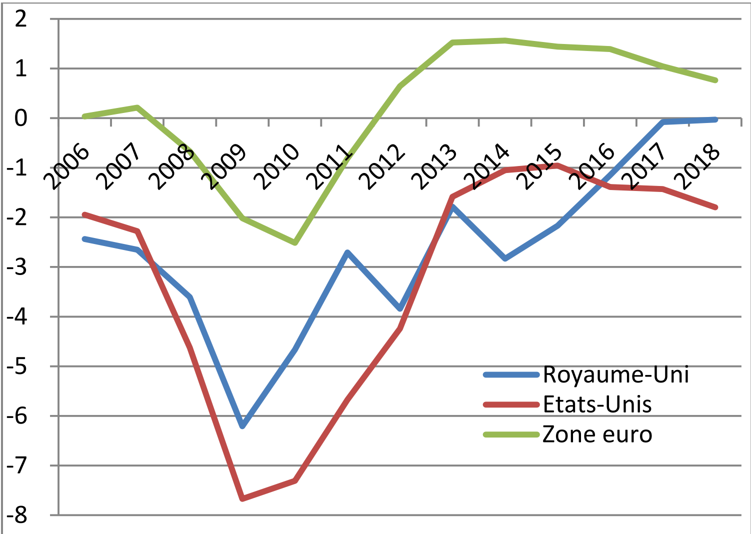
Source: AMECO database.

The euro area's fiscal policy

As EU regulations currently stand, fiscal policies are still governed by the Stability and Growth Pact (SGP) with its corrective arm which aims to bring deficits back to under 3% of GDP and its preventive arm which targets fiscal balance between revenue and expenditure. Since 2012, a Fiscal Compact has been associated with the SGP. It introduces a structural budget deficit target of a maximum of 0.5% of GDP, adjusted for cyclical variations. These two initiatives rein in the use of discretionary policies over time – fiscal stimulus is allowed but it must be temporary, which can mitigate its effectiveness if it has not yet yielded results – and, whilst there is still a public deficit, governments may elect to cut back automatic stabilisers, i.e. revenue and expenditure that are contra-cyclical, for instance by cutting welfare benefits.

The 2009 recession took place against this institutional backdrop. Initially the recession caused governments to give public deficits and debt free rein under the impetus of automatic stabilisers and coordinated fiscal stimulus. But, without waiting for positive results from this stimulus and following recommendations from the European Commission that was looking to ensure compliance with the SGP, in 2011, governments introduced budgetary restraint policies to bolster public finances. The outcome was the remarkable return to the black of the European primary balance, adjusted for the business cycle (chart 2). This fiscal indicator points to the discretionary element of fiscal policy. Its level is in stark contrast to that of the United States and the United Kingdom.

Chart 2. Cyclically-adjusted primary balance as a % of potential GDP.



Source: OECD.

Royaume-Uni	United Kingdom
Etats-Unis	United States
Zone euro	Euro area

The mainstreaming of austerity policies in Europe put a dampener on growth (Blanchard and Leigh, 2013). As a result, they also failed to achieve their main goal. Cuts in government expenditure and tax hikes (tax bases and rates) were offset by higher spending on welfare benefits and lower tax revenue. Public deficits were not reduced and this helped increase debt levels.

Ultimately, the coordinated implementation of these policies was in line with the rationale underpinning the adoption of the SGP and fiscal convergence criteria prior to the adoption of the euro according to which fiscal stimulus policies were ineffective. However, the facts and empirical research have established the opposite (see, recently, the chapters devoted to the multiplier effect in Marimon and Cooley, 2018).

Monetary policy

As European fiscal policies failed to both close growth gaps and contain excessive government deficits following the 2008 crisis, the ECB was forced to take action by introducing non-standard policies in 2012. During the summer and the spillover of Greece's financial woes to other so-called peripheral countries (Portugal, Spain and Ireland), the President of the ECB declared that the bank would do "whatever it takes to preserve the euro" and announced a conditional government bond purchase programme (for bonds with maturities up to three years). Three years later, he was to further announce implementation of the systematic monthly purchasing of government, and later private, bonds with all maturities.

As the purpose of this policy is to lower interest rates on debt, it therefore interacts with fiscal policy financing. In doing so, it can influence the behaviour of governments which may potentially be less prepared to contain their deficits. The interaction between monetary and fiscal policies raises questions as to the extent of the ECB's independence in relation to European governments. This led to it being subject to actions before the German Constitutional Court. To date, the Court has always held that the ECB had not exceeded its main mandate (the pursuit of price stability) in rolling out its non-standard policy. This should underscore the fact that legal independence is not irreconcilable with applying a monetary policy with secondary fiscal goals.

These interactions could also have ramifications on financial risk sharing between euro area Member States. By buying government bonds which may be burdened by national risk premiums (liquidity and/or default), the ECB could spread the cost of a liquidity or default crisis affecting a Member State between euro area Member States. To avoid any risk sharing, the ECB purchases bonds in proportion to each Member State's contribution to its capital. As a result, and as an example, it acquires more German government debt than Portuguese government debt. It also transfers risks to the central banks of countries whose debt it acquires.

The ultra-accommodative monetary policy implemented by the ECB since March 2015, which involves keeping loan interest rates very low, is having an impact on the global savings/investment balance. The euro area has a substantial current account surplus and, therefore, an excess of domestic savings in relation to investment. In this respect, the ECB's policy is geared towards restoring the balance by lowering the cost of investment and the returns on savings. Conversely, austerity policies aim to foster savings at the expense of investment. Consequently, the lack of coordination between monetary policy and fiscal policies has caused a sub-optimal balance: each policy has distanced the other from its target. The rollout of the Investment Plan for Europe ("Juncker Plan") could be seen as an acknowledgement of the shortcomings of fiscal austerity during crises.

The European Stability Mechanism (ESM)

The budgetary problems faced by euro area countries did not only drive monetary policy to replace fiscal policies. They also led to the setting up of a new crisis management institution authorised to make loans between euro area Member States.

Back in May 2010, the risk of the Greek government defaulting spurred the drawing up of a bailout programme which laid bare one of the drawbacks of European governance, namely the lack of a lender of last resort. To address this, and to handle the continuing Greek crisis, the euro area established a European Financial Stability Facility (EFSF), which ultimately became the ESM. The latter has a conditional lending capacity for countries experiencing financial hardship. The ESM can grant loans provided that they are accompanied by loans from the IMF or that the debt restructuring conditions have been decided upon beforehand.

The ESM now enshrines the principle of solidarity laid down in the Treaty on the Functioning of the European Union. It enables *ex post* coordination of economic policies but does not have special authority for crisis prevention. In this respect, the ESM is not an international monetary fund for European countries. It is not a replacement for the SGP and contributes to the complex nature of the European institutional system as the European Commission, the Eurogroup, the Council and sometimes even national parliaments, are party to agreements on the loans granted as part of the ESM. As a result, this form of *ex post* coordination is both taking shape and bearing fruit slowly.

Although it is not comprehensive, the insurance afforded by the ESM has also accentuated the moral hazard, meaning the systematic under-estimation of the risk by the insured parties (Wyplosz, 2017). There may be a lack of coordination between lenders and borrowers with the former being insufficiently aware of the latter's capacity and the borrowers considering that the cost of their risk-taking will not be fully attributed to them. Under-estimating the risks of default triggers huge indebtedness and is one of the causes of self-fulfilling crises in the event of the reversal of expectations or a sudden loss of confidence.

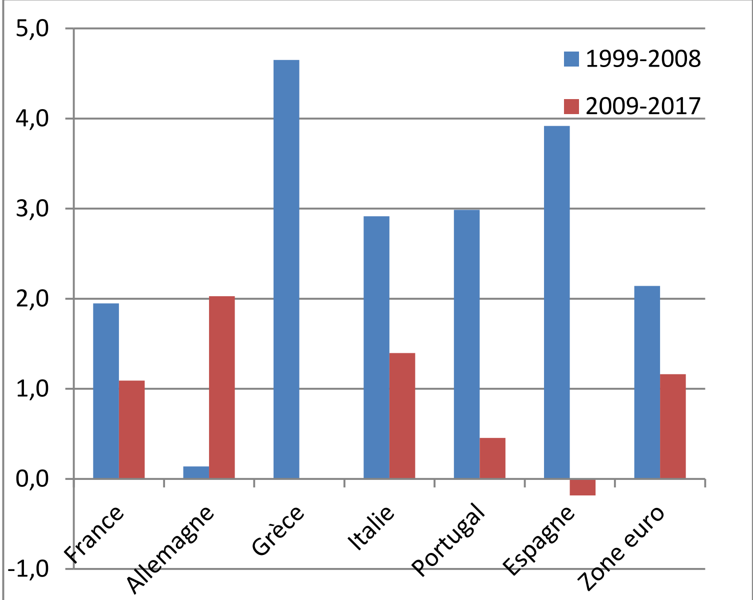
Structural reforms

The fallout from the 2008 crisis for the euro area has been heightened by the variations in labour costs between Germany and peripheral countries. Between 1999 and 2008, unit labour costs – the difference between wages and productivity – increased at a sustained pace in Greece, Spain, Portugal and Italy whilst wages rose at the same rate as productivity in Germany (chart 3). These differences created competitiveness gaps and varying changes to current account balances. Germany accumulated surpluses and credit claims whereas the peripheral countries amassed deficits and private debt.

However, since 2008, Germany has experienced the largest increase in unit labour costs whilst these have decreased significantly in the peripheral countries, with Spain and Greece leading the field. Both imbalance in the labour market and divergences have been mitigated by better coordination of wage policies in relation to productivity and between euro area Member States.

Nevertheless, this coordination has been grounded in wage cuts in these peripheral countries and this has had a strong impact on growth. The social and economic costs of structural reforms have not helped the euro area to rapidly recover from the crisis. In the future, an increase in the surplus of the euro area's current account, to which all Member States, except France, contribute, will create the risk of the euro appreciating on the foreign exchange markets. With all other things being equal, this would lead to a fall in the price competitiveness of European businesses. The risk would be increasingly high under the impetus of a shift in ECB policy towards exiting its ultra-accommodative policy.

Chart 3. Unit labour costs, average annual growth rate by sub-period, as a %.



Source: OECD.

France	France
Allemagne	Germany
Grèce	Greece
Italie	Italy
Portugal	Portugal
Espagne	Spain
Zone euro	Euro area

Bolster European economic governance

Crisis exit management took place in several stages: mistakes in coordinated fiscal policy management; lack of coordination with the ECB which was forced to address shortcomings in fiscal policies; the implementation of a crisis management institution that failed to provide a response to the issue of the moral hazard between euro area Member States; and a coordination of structural reforms which, whilst improving current account balances, put a drag on short-term growth.

The "improvised" nature of this crisis management must not be repeated. In light of the much higher levels of public and private debt compared to the pre-2008 period, a new financial crisis would be disastrous, unless the response was appropriate in terms of both timing and the instruments rolled out. Economic policies should be able to alleviate a crisis as rapidly as possible and, most importantly, not help worsen it.

To this end, fiscal policies would need to be fully counter-cyclical under the effect of automatic stabilisers: deficits would have to be able to increase for the duration of the crisis before falling once it was over. According to the European Commission (2018), the ability of automatic stabilisers to lessen cyclical changes varies greatly between EU Member States, and is far from perfect. As a result, investment is probably required to boost these stabilisers' performance levels. This would involve going beyond the adoption of a public expenditure rule adjusted for automatic stabilisers, as recommended by Bénassy-Quéré *et al.* (2018), because these stabilisers also need to be bolstered by more progressive taxation and more generous unemployment benefits respectively.

The coordination processes between monetary policy, on one hand, and fiscal policies, on the other, also require improvement. Both these policies must have the same goal, namely to stabilise economies in times of crisis. Lessons must be definitely drawn from mainstreamed and early fiscal austerity, introduced prior to the end of the crisis, and wriggle room needs to be freed up to be able to address another major crisis in the future.

The fact remains that crisis prevention is a priority. This necessarily involves a better match between savings and investment. As bank financing is predominant in the EU, the banking system also needs to be robust and resilient. As a result, the confidence of households and non-financial companies in banks should not be overlooked. This calls for the completion of banking union with the creation of a European Deposit Insurance Scheme (EDIS). To this end, a further stage in coordination between euro area Member States is required.

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