TWO CRISES, TWO RESPONSES

THE GREEK CRISIS has degenerated into a much-needed but chaotic debate about crisis management and crisis prevention in the euro area. Intellectual and policy confusion has been widely exposed, raising questions about the consensus that underpins the single currency.

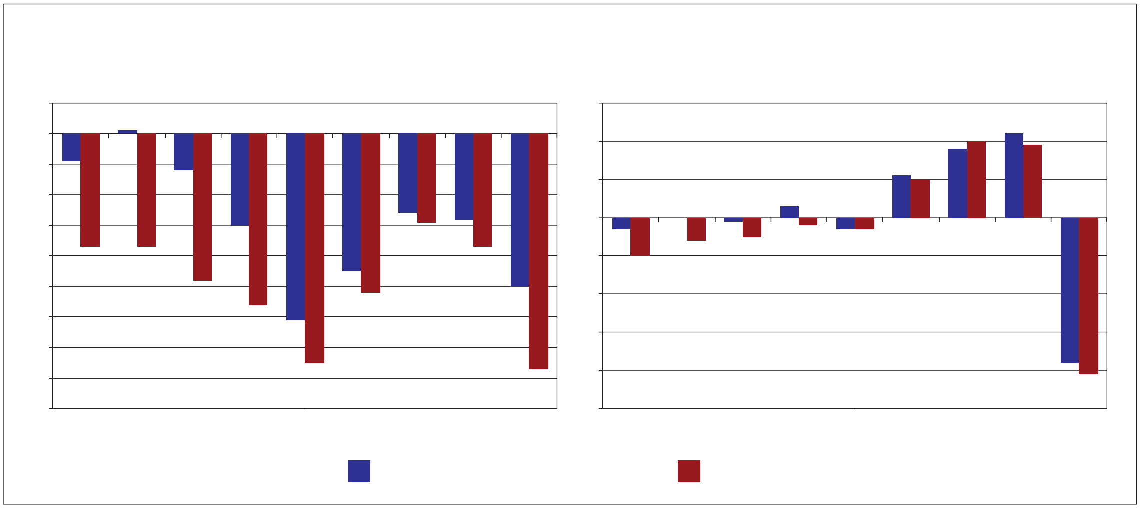
To be fair, Greece is a special, rather pathological case: no other euro-area country exhibits a similar combination of budgetary misreporting and misbehaviour. Nevertheless, many other euro-area members are having to face major macroeconomic challenges. Spain, in particular, exemplifies another type of crisis that does not result from a lack of budgetary discipline, but originates from a domestic credit boom and its wage and price consequences.

Global capital markets were first to sound the alarm about the situation in several euro area countries: for several months, spreads on bond and credit default swap markets signalled diminishing investor confidence. Speculators have been blamed for triggering crises, but had the EU acted earlier, domestic imbalances would not have resulted in such tensions over external financing.

The current situation is a severe test. It is not surprising that it comes now: a lesson from fixed exchange-rate regimes is that weaknesses take several years to emerge. What is worrying is that these weaknesses have become evident at a time when the world environment is exceptionally challenging.

The test concerns the euro area as a whole. Confidence in the euro is now affected by increasing doubts about the area's functioning and resilience in times of turmoil. How this test is tackled will have a decisive bearing on the future of the euro. If the right lessons are drawn, the euro will emerge stronger; if not, it will emerge weakened.

To meet the challenge, clarity about the various types of crisis is needed so that new principles for action can be established. The essential pillars governing



Source: Bruegel calculations based on European Commission, DG ECFIN. Notified deficits are the estimates released in spring of the following year.

implicit assumption was that the private sector is inherently stable. The dangers of such neglect start-

of domestic budgetary institutions, especially statistical institutes and fiscal oversight councils.

B. Crisis management

Crises happen even with the most

feature of the recent European discussion on crisis management[5]. This should be remedied by sticking to the no-coresponsibility principle while putting in place a clear and predictable conditional assistance regime.

The question then is who should be in charge of crisis management in the euro area? The IMF, the EU, or both together?

A purely IMF approach is not desirable because it would risk creating incompatibility between IMF and EU policy requirements. Whereas the IMF has full leeway when negotiating a programme with a country that is not part of a regional arrangement, EU members (and especially euro-area members) are part of a policy system that needs to be taken into account when designing a programme.

A purely EU solution would also have problems. First, it would amount to creating an entirely new legal and financial apparatus. IMF conditional assistance rests on specific agreements, procedures and instruments that do not exist in the EU. This is why the EU relies on joint programmes with the IMF for providing assistance to its non-euro members: it makes good sense for the European Commission to benefit from the IMF's extensive worldwide experience. The second problem is that EU loans under the balance-of-payments programme are financed exclusively by funds raised by the EU on capital markets. These EU bonds are, however, fully guaranteed by the EU budget. As long as the sums involved are relatively small, as in the case of Hungary, Latvia and Romania, the tiny size of the EU budget is not a severe constraint. The matter would be totally different if larger EU countries needed assistance.

These considerations call for establishing a framework for joint EU-IMF assistance to countries in the euro area. A solution of this sort could also serve as a model for IMF agreements with other regional groupings, not least the Asian Chiang Mai initiative, and could help make cooperation between the IMF and such groupings more effective and efficient.

Recommendations

- Extending Article 143 to euro-area countries. It would be desirable to modify Article 143 so that the EU conditional loan facility can be made available to euro-area members facing financing difficulties. Loans could still be granted, as has always been the case with MTFA loans[6], as part of a package of aid put together with the IMF, a possibility that Article 143 makes explicit.

- Defining a framework for joint EU-IMF assistance to euro-area members. This framework should outline the principles and procedures for cooperation, and, in particular, make clear that the conditions set by the IMF for assisting a euro-area

Coordination. Article 121 is the basis for economic suriosance, both in a bilateral and a multilater-

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agreement on desirable budgetary outcomes, it would be absurd to impose balanced or near-balanced current accounts. One motive for the euro was indeed to encourage flows of savings across borders. Furthermore, economic analysis does not provide numerical benchmarks for determining what is a 'good' current-account balance (Blanchard and Milesi-Ferretti, 2009). Thresholds can be used to trigger examination and assessment, not to determine policy action.

A more promising avenue is to monitor wage and price developments systematically – in effect to carry out surveillance of real exchange rates. The EU has a tradition in this respect, which was strangely discontinued with the introduction of the euro: in the Exchange Rate Mechanism, no country could realign (change its nominal exchange rate) without the consent of its partners precisely because of the effect on competitiveness (ie real exchange rates). But nowadays a country can unilaterally modify its real exchange rate, for example through a combination of VAT increases and cuts in social security contributions.

Evidently, the purpose of this surveillance should not be to prevent changes in the real exchange rate, when they are justified on grounds of relative economic performance. As Figure 3 shows, the performances of euro-area members in this respect vary.

Whether the focus is on current account balances or real exchange rates, the surveillance process must have a strong euro-area dimension because, barring changes for the area as a whole, a country's current account deficit (or competitiveness loss) is another country's surplus (or competitiveness gain). Therefore, analyses need to be done and recommendations made for all the players in the system. As recognised in the Eurogroup note of 15 March (Eurogroup, 2010), when adjustment is needed, it concerns both deficit and surplus countries.

At the national level, governments should monitor competitiveness and act when needed. Most lack an appropriate policy framework and instruments, but some do have them (Box 2, overleaf). These (mixed) experiences could provide inspiration for governments to put in place mechanisms adapted to the institutional features of national wage and price-setting.

Recommendations

- European competitiveness-monitoring framework. The Commission should take responsibility ... ad61(e-)183.re1.07l15.7(ds.(

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8. Dullien and Schwarzer (2009).