Lorenzo Bini Smaghi: The challenges facing the euro area

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Official Monetary and Financial Institutions Forum (OMFIF) Meeting, Abu Dhabi, 1 November 2010.

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Over the coming months and years the euro area will face two types of challenges. The first one – which is very similar to that of other major advanced economies – is to consolidate public finances and at the same time restore economic growth. The second challenge – more idiosyncratic – is to strengthen the institutional basis of the single currency so as to avoid having to face again the problems we experienced in the recent crisis.

Let me address these two challenges in turn.

Concerning the current economic challenges, euro area policy makers share the following five points:

1. The crisis is the result of a combination of structural and cyclical factors. Overcoming the crisis thus requires both macroeconomic and structural policies.
2. Macroeconomic policies have been quite effective in counteracting depressionnary forces, especially after the Lehman Brothers' crisis, but they cannot by themselves bring the economy back to the pre-crisis growth path.
3. Structural measures are essential to increase growth potential of euro area economies over the coming years. They affect different policy areas, such as the labour markets or the banking system, which in many countries need to be strengthened and restructured.
4. As far as monetary policy is concerned, the non-standard measures implemented during the crisis have contributed to the smooth functioning of financial markets. The flow of credit to the private sector is progressively rebounding. The exceptional measures are being removed as economic and financial market conditions improve.
5. Fiscal policy needs to be adjusted and brought on a sustainable path, with a view to preserve – or restore – the confidence of financial markets.

I would like to elaborate on the last point, i.e. fiscal consolidation.

Although there is a broad agreement on the need for consolidation in the euro area, the situation differs across countries. Some are in a better condition, either because they kept firmer control over public finances prior to the crisis or because they are experiencing stronger growth performance. The situation is more challenging in countries where economic growth is sluggish and large fiscal imbalances have been accumulated. There is a risk of a vicious circle, which can develop as a result of the following:

1. Restrictive fiscal policies are politically difficult to implement and thus tend to be delayed, because of the feared negative impact on the economy.
2. As countries show hesitation in addressing their budgetary problems, access to financial markets tends to become more difficult.
3. When market access deteriorates, the budgetary measures required to restore confidence are much more drastic and painful.

Some observers, especially outside Europe, have suggested that European democracies are not able to deal with such a vicious circle. They consider that the only way out of the dilemma is a default, or a partial default. Some have – even recently – voiced openly this view, maybe with the intent to influence financial markets and increase the probability of such an event to

occur; an event from which they would presumably take profit. This view, however, does not take into consideration that in advanced economies a sovereign default is very damaging for the citizens of the country concerned, as it would drastically affect their wealth. Increasing the primary surplus, either by cutting expenditure or by increasing – in certain cases by starting to pay – taxes, has in most cases less damaging effects on the economy and on citizens' well-being than a cut in the value of their financial assets.

To sum up, consolidating public finances is painful economically and politically, but the alternative is worse. Governments in Europe are fully aware of this.

Let me move to the second issue, which concerns the strengthening of the institutional framework underlying the single currency. To understand the issue one should first consider what did not work as expected during the first ten years of the euro. Two main things did not work.

First, in some countries the behaviour of the private and public sector was not fully consistent with the long run requirements of a single currency area. Divergences may occur in currency unions, or even within countries, as some regions may grow more than others and experience booms which then burst. In the euro area, the lack of a federal budget transforms country-specific shocks into public finance shocks and thus financial stability shocks. This is why a currency union like the euro area needs a system of discipline for both the public and the private sector, to be exercised at the level of the member states.

The euro area had a system aimed at disciplining the public sector, i.e. the Stability and Growth Pact (SGP), with rules and procedures aimed at avoiding excessive deficits. The Pact worked in some cases, but not all. The main reason has been that the Eurogroup, which comprises the Finance Ministers of the euro area and is in charge of implementing the SGP, has not been able to put sufficient pressure on countries to ensure fiscal discipline. To quote a frequently used sentence, "*When potential future sinners have to judge current sinners, the tendency for forgiveness prevails*".

The euro area had no system to discipline the private sector and avoid imbalances, especially for catching up countries. Even when presented with evidence about the growing divergences in cost competitiveness, the Eurogroup did not show much interest and did not take action. However, there is substantial evidence showing that in countries which experienced major competitiveness losses public sector wages often led the way for pay rises in the private sector. Furthermore, excessive private credit growth, especially mortgages, has often been the result of distortionary tax treatments.

How can the problem be fixed? There are two avenues. The first is to recognize the limited powers of the Eurogroup and move to a rules-based system, with automatic procedures and sanctions. That was the approach followed by the ECB in its published proposal for reform of the SGP, and partly also the approach of the European Commission. The Heads of State and Government of the European Union followed a second avenue, as they wanted to retain the ability to decide on budgetary matters, in particular concerning the imposition of sanctions on countries not respecting the rules. They did not want to deprive themselves of their powers in favour of the European Commission, nor to bind themselves with a rules-based approach. This position might be understandable from a political point of view. But it doesn't resolve the problem that I raised previously, concerning potential sinners forgiving the current ones. No change has been made to the system of governance aimed at reducing the perverse incentives. Why should the Eurogroup be expected to behave in the future any differently than in the past?

The question remains unanswered. The discussion is not over yet, as the new mechanism will now have to be discussed and agreed with the European Parliament. The Parliament might come up with ways to make the Eurogroup more accountable in its implementation of the SGP, with a view to safeguard the general interests for sound budgetary policies against the incentives for mutual forgiveness.

The second failure was to assume that simply by adopting a system of rules there would be no more crises. If there are no crises there is no need for a crisis management framework. This was very naïve and ultimately turned out to be a mistake. Experience shows that crises do occur, even in the best of worlds. Of course, it's not easy to build a crisis management framework. But it might not be that complicated either, learning from the experience of the International Monetary Fund and the European Financial Stability Fund, which has just been built to address the current crisis.

I believe that there is a broad agreement on what we don't want. We don't want a system which:

1. creates moral hazard and induces countries to embark on loose policies in the expectation that they would be bailed out.
2. makes taxpayers (of other countries) having to bail out bad investment decisions made by the private sector.
3. creates incentives for speculative attacks that could push into bankruptcy even an otherwise solvent country.

To achieve these objectives, we don't have to reinvent the wheel. We have the model of the IMF to guide us. I would just make three main points in this respect.

First, the best way to avoid moral hazard is to attach strong conditionality to any support package. In addition, any financial support has to be at penalty rates, as it is the case for the IMF. Over time the IMF-style conditionality has led to a sharp reduction of the number of countries resorting to the IMF. No country turns happily to the IMF for financial support.

Second, the best way to avoid that taxpayers bail out private investors is to ensure that any support provided by the new European mechanism has preferred creditor status, like the IMF. This means that the funds lent by the institution have to be reimbursed first, before the private sector. Again, the experience shows that countries do reimburse the IMF. When countries are in arrears with the IMF – which is currently the case of Somalia, Sudan and Zimbabwe – they have *de-facto* exited the International Community. The existing EFSF does not have preferred creditor status because it is the result of an inter-governmental agreement rather than a supra-national institution. The European Investment Bank, instead, which is inscribed in the EU Treaty enjoys preferred creditor status. Given that the new mechanism will be created as a result of a Treaty change, it can have a preferred status.

Third, the best way to avoid triggering speculative attacks against the member states is to link the financial support provided to countries to the latter's ability to repay, in particular to debt sustainability. There should be no automatic mechanism linking financial support to debt restructuring, because it would attract speculative pressure and precipitate a crisis, even for countries that are solvent.

This raises the issue of how to deal with countries that are not in a position to repay all their debt. Such a possibility cannot be excluded. Again, the experience of the IMF shows that there have been cases of debt restructuring associated with Fund programmes, even though debt restructuring is not considered in the Articles of Agreement of the IMF. Out of 113 IMF support programmes over the last 20 years, only 19 countries defaulted or restructured their debts. The countries which went through such action – Algeria, Argentina, Cote d'Ivoire, Dominican republic, Ecuador, Gabon, Grenada, Indonesia, Kenya, Moldova, Nigeria, Pakistan, Paraguay, Russia, Seychelles, Ukraine, Uruguay, Venezuela, Zimbabwe – have characteristics which are not very similar to euro area members.

In all these cases restructuring was done on a case-by-case basis, depending on the specific circumstances. It is suggested by some that precise rules and conditions for debt restructuring should be attached to the creation of the new European mechanism, with a view to achieve an orderly restructuring. In my view this is "unnecessary, undesirable, and unlikely", to quote a recent Staff paper by the IMF.

It is unnecessary because experience shows that restructuring can take place even without international norms and without the IMF being given specific powers in this field. It is undesirable because there is a risk that norms designed at addressing problems of the past are not any more valid for complex financial systems and may even aggravate the situation. Most crises of the past had to deal mainly with foreign creditors of developing countries. In advanced economies the restructuring of the public debt would have to involve a much larger number of financial assets and liabilities, including those of the domestic banking system *vis-à-vis* residents and non residents. It can be easily seen that there can hardly be anything "orderly" in such a process.

Attempts to work on this issue should certainly not be discouraged. The IMF experience in this field is again telling. There studies and discussions on the design of a mechanism for Sovereign Debt Restructuring took much effort and lasted several years. The result was intellectually interesting but ultimately not agreed, neither by the sovereign states neither by financial market participants. This doesn't mean we shouldn't try again. But we should be aware that calling for an orderly debt restructuring mechanism sounds nice and is costless. Designing and implementing it is somewhat different, and has not been done yet, like many other nice catchwords which have attracted our intellectual interest in the past.

Some work can be done, and has been done, in developing mechanisms which make it easier for creditors and debtors to agree on revising the contractual terms. Substantial work has been done for instance on collective action clauses, which set minimum thresholds for debtor representation needed to agree on a restructuring. These mechanisms exist currently in many national laws. It might be more promising and pragmatic to further explore this avenue.

To conclude, the euro area is facing several challenges. Some are similar to those of other countries, some are idiosyncratic. If the experience of the last few months teaches us something it is that Europeans are fully aware of these challenges and want to address them to make sure that the euro area gets out from this crisis stronger than before. Many of the actions taken so far will indeed make it stronger and more resilient. On other measures the discussion is still ongoing and the jury is out.

I recognize that seen from far away, it's sometimes difficult to understand what's really going on in Europe. It's difficult to follow the debate, to forecast the outcome. This is perfectly understandable. As in all democracies decisions are preceded by intense debates. In Europe we have the additional complication that the debate takes place not only within countries but also between countries, in the open. When decisions are made, and compromises are struck, which by definition cannot make everybody happy, additional debates develop. This may be disorienting for outsiders. You may need a compass.

We have a clear compass to use in Europe, it's the Treaty. It guides us every day, for instance in the conduct of monetary policy in the euro area, providing the central bank with a clear objective for the benefit of European citizens; an objective which has been achieved over the last ten years. The Treaty also guides other institutions in their functions. This might not be enough, as the compass may not always be sufficiently precise. What's important is to recognize such shortcomings and stand ready to address them. What one should take from the series of decisions that have been made over the last few months, including that of changing the Treaty, is the willingness to build a stronger Europe, a stronger and more resilient euro area, capable of facing future crises.

Thank you for your attention.