Centre for Economic Policy Research
POLICY INSIGHT No.61
MARCH 2012

From vicious to virtuous: A five-point plan for Eurozone restoration

Marco Buti and **Pier Carlo Padoan**
European Commission; OECD

The economic and financial crisis in the Eurozone is in its fourth year. In late 2011, it had evolved dangerously into a vicious circle of sluggish growth, tensions in sovereign debt markets, and banking sector fragility. Investor confidence in the Eurozone seemed on the verge of collapse, many sovereigns and banks struggled to access market funding, and the future of the Eurozone was widely questioned in financial markets and the policy debate.

While tensions have eased recently, the Eurozone is still in a situation in which multiple equilibria can materialise.

- In a vicious circle, confidence falls and deteriorating financial market conditions jeopardise debt sustainability, more so in an environment of low growth.[1]
- In a virtuous circle, things work in reverse – rising confidence strengthens market sentiments and growth, thereby improving debt sustainability and strengthening market confidence and growth further.

The horns of the dilemma are that shifting from a vicious to a virtuous circle requires time, but markets are impatient. What is needed is a 'confidence bridge' – a set of decisive and credible policies that can turn the economy around, thus realigning expectations that the good equilibrium (sustainable growth and debt burdens) will ultimately emerge. Securing a good equilibrium for the Eurozone is possible. Developments since the beginning of this year have surprised on the upside.

- The ECB's provision of longer-term bank funding (the famous Long Term Refinancing Operation, LTRO) has had a powerful effect in boosting confidence; fear of an imminent bank failure and a credit crunch have receded.
- Despite the downturn towards the end of 2011, there are signs of stabilisation and an increasingly likely recovery in the second half of 2012. Sovereign debt markets have improved, as reflected in successful bond auctions and declining yields.

These favourable trends are in no way a reason for European policymakers to relax. Rather, they offer the opportunity to focus on a more strategic response. It is essential that this opportunity is not squandered.

Further measures are required to address unfinished business and to avoid the establishment of a bad equilibrium.

A five-point strategy to ensure the good equilibrium prevails

A strategic response that will bring the Eurozone towards a good equilibrium is based on five mutually reinforcing points (see European Commission 2011):[2]

- Remove uncertainty about a second programme for Greece and undertake credible economic adjustment in other vulnerable members.
- Establish an adequate firewall against contagion in sovereign debt markets.
- Ensure that EU banks are sufficiently capitalised.
- Reform the framework for economic governance in the Eurozone.
- Implement policies to boost growth and address imbalances.

1 A formal analysis is provided in Padoan, Sila and van den Noord (2012).

2 Leaders of Eurozone Member States have committed to these last October (European Council 2011).

To download this and other Policy Insights, visit *www.cepr.org*

Progress is being made on all five elements. However, the pace of implementation is not uniform and failure to make sufficient progress on any single element – possibly motivated by complacency over recent developments – will undermine the overall strategy. The possibility of falling back towards a bad equilibrium is still uncomfortably high.

Importantly, these policies need to be implemented as a coherent package – because of the systemic nature of the problem, a partial solution is bound to be ineffective and lack credibility.

Reasons for optimism in vulnerable members

Eurozone finance ministers agreed a second programme for Greece, while Greece's creditors have agreed to a historic debt restructuring. The programme implies a very substantial adjustment in the Greek economy in the coming years, restoring public-debt sustainability, safeguarding financial stability, and boosting competitiveness.

In the months ahead, Greece, the troika, and Eurozone members must ensure its full implementation under a regime of strict monitoring and effective technical assistance. The agreement of private bond holders to accept the terms of debt forgiveness and exchange gives Greece much needed further fiscal breathing space.

There is also reason for optimism with respect to other vulnerable members.

- The programmes for Ireland and Portugal are on track and growth is returning in Ireland, even if a further substantial economic adjustment will be required in coming years.
- New governments in Italy and Spain have announced their own strategies for economic adjustment, and implementation is underway.

The threat of a sovereign default in these member states has receded, thereby quelling market speculation of an imminent break-up of the Eurozone. Available evidence, such as the OECD responsiveness to reform indicator, shows that structural reforms are particularly strong in the vulnerable Eurozone nations (see below).

Adequate sovereign firewall

The 'firewall' for sovereign debt must be of sufficient size and quality to dispel investor concerns that economic or financial problems in any one Eurozone state could undermine financial stability in the Eurozone as a whole. There has been substantial progress in this respect.

- Eurozone nations have accelerated the establishment of the ESM by one year to July 2012.
- There is an agreement to review the adequacy of the combined EFSF and ESM resources by the end of March.

A higher ceiling would also help to unlock a further contribution to the firewall from a substantial increase in IMF resources.

Primarily relying on the EFSF/ESM (or the IMF) to support vulnerable members or intervene in markets has tangible advantages over an overstretched role for monetary policy in providing such support. It would allow for conditionality to be imposed and would assign costs explicitly and transparently to the fiscal authorities.

Progress on bank recapitalisation and funding

Recapitalisation of Eurozone banks is progressing successfully. Despite widespread initial fears, banks will easily reach the 9% Core-Tier-1 capital ratio target set for them by end of June 2012 (European Banking Authority 2012). The bulk of the required deleveraging will be achieved through capital increases rather than through asset shrinkage. It is important to ensure that banks increase their capital levels to avoid a process of credit curtailment and generalised bank deleveraging.

The banks' liquidity situation has markedly improved over recent months. Against a background of still ill-functioning interbank markets, the ECB's recent three-year LTRO moves and relaxed collateral requirements have defused an imminent liquidity squeeze that threatened some vulnerable members. As such a squeeze could have reignited the negative feedback loop between balance sheets of the sovereigns and banks in these countries, the LTRO walled off an important source of negative shocks.

New Eurozone governance framework

The framework for economic governance in the Eurozone is being radically overhauled.

- The so-called six-pack of legislative measures to reinforce economic and budgetary surveillance was adopted in December 2011 and is already operational.
- As an important milestone and part of its new macroeconomic imbalances procedure, the Commission adopted last February its first Alert Mechanism Review (European Commission 2012).

- The additional two pieces of legislation to complete the reinforcement of surveillance are in the final stages of agreement between the European Council and Parliament.

Meanwhile, the new fiscal compact is in the process of ratification by the members.

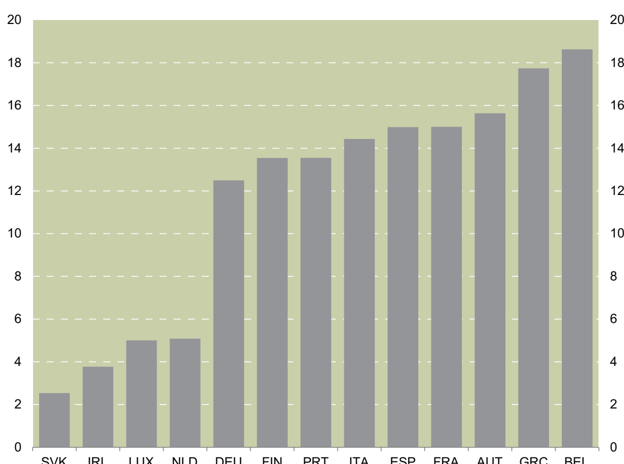
A decisive push on structural reforms

Low economic growth and rising unemployment remain major weak spots in the crisis management strategy. Economic activity and employment must be strengthened by appropriate policy actions and reforms at both national and EU levels. The EU can contribute significantly to this task by further deepening and strengthening the single market, in particular for services. Members should address decisively rigidities and other weaknesses in their product and factor markets.

Weak economic growth remains the key challenge

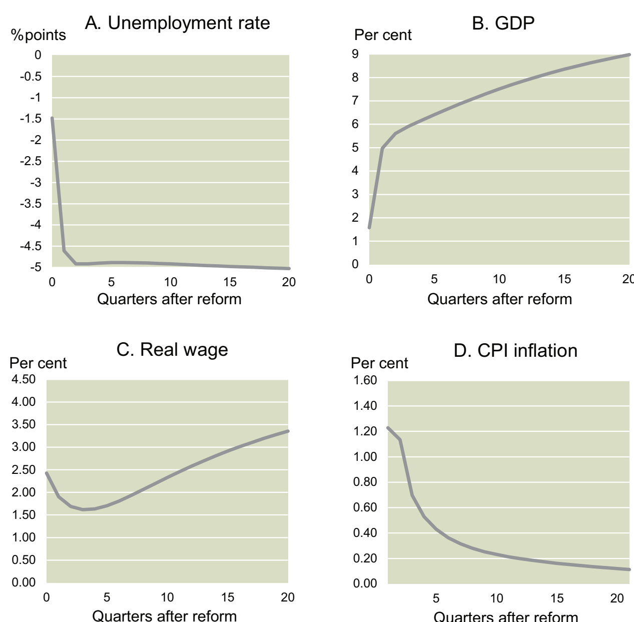
The unsatisfactory growth performance of, and imbalances in, the Eurozone over the past decade originated in poor structural settings that discouraged productive investments in some sectors, contributed to the instability of the housing market, and failed to keep wage and price developments in line with productivity. A credible and ambitious strategy of structural reforms that can address these weaknesses would have a tangible impact on economic growth and debt sustainability, in particular in vulnerable countries (Figure 1).

Figure 1. Potential gains from broad reform package, ten-year horizon; GDP levels, %



Often, the fruits of reform efforts are visible only over the medium term. A credible reforms package, however, can also generate positive effects in the short term in terms of confidence and performance (Figure 2), while short-term costs can be vastly overstated (OECD 2012).

Figure 2. Short-term effects of structural reforms



Note: The size of the simulated reform corresponds to a reduction in the value of each policy parameter from a hypothetical "rigid" economy to a hypothetical "flexible" economy (calculated as an average of "flexible" OECD countries). The composition of the basket of benchmark OECD countries is slightly different across policy parameters. See Cacciatore *et al.* (2012) for details.

Economic growth in the Eurozone remains subdued at best. The potential growth rate of the Eurozone is estimated to be around 1.25%, with markedly lower rates in some of the countries facing intense market pressure. Stronger growth would restore confidence, improve debt dynamics, and facilitate exit from the crisis, particularly in countries with high accumulated debts.

From this observation, some classic objections to the strategy of fiscal consolidation in the Eurozone follow:

- Policies should, at the present juncture, be geared to strengthening aggregate demand, in particular in the most vulnerable members.

- Such an approach could create the space for implementing reforms.

- Structural reforms and fiscal retrenchment cannot be pursued simultaneously, as their highly compounded negative impact on aggregate demand and economic growth would be self-defeating.

- Ultimately, fiscal consolidation in the Eurozone should be an objective for the medium term, and postponed in the short term.

However, these criticisms neglect the four critical points. First, the extraordinary pre-crisis build-up of debt to largely unsustainable levels has left most

Eurozone economies with the task of redressing imbalances and embarking on unavoidable deleveraging; high debt permanently weakens economic growth.

Second, risk aversion, along with risk premia, have spiked since the global crisis of 2008-9, ending a long period of appetite for high risk and compressed premia. Current heightened risk aversion makes deleveraging all the more necessary and, at the same time, more painful in the short term.

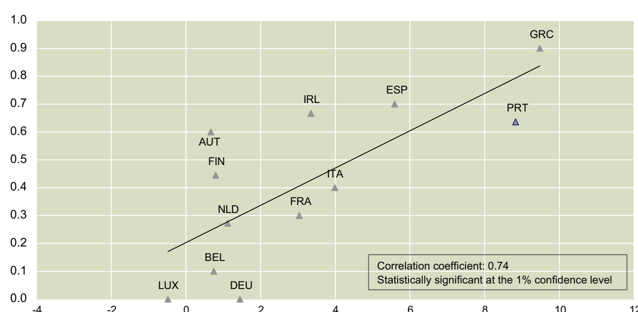
Third, low interest rates and the excessive lending and borrowing prior to the crisis had not only led to growing debt levels, but also to an allocation of resources that has proven unsustainable and that must be corrected.

Finally, in a situation of multiple equilibria (where confidence plays a crucial role), the distinction between short-term and long-term measures is misleading and possibly dangerous. On one hand, the label 'long term' may be viewed as an excuse to postpone action and, on the other, short-term measures may weaken confidence that medium-term dynamics will lead to the good equilibrium (Padoan, Sila and van den Noord 2012). This legacy defines and limits the role of active demand management and calls for sound fiscal policies. Clearly, the scope, pace, and approach to fiscal consolidation should not be uniform across members but, rather, reflect the specific feature of each country, its fiscal position and the strength of its economic conditions. In all cases, fiscal adjustment should be growth-friendly.

The reinforced governance framework of the Eurozone will help members to stay on track towards these goals. Experience shows that fiscal discipline is especially at risk in countries where policies are more short-sighted, possibly driven by the electoral cycle. In such a setting, a strong external anchor – as provided by the recently reinforced fiscal governance rules in the Eurozone – can help in keeping up necessary reforms (Buti, Röger and Turrini 2009). Available evidence points, remarkably, to the fact that structural reform efforts during the current crisis seem to be positively correlated with fiscal consolidation efforts (see Figure 3).

In this context, restoring the sound functioning and stability of financial markets remains a key objective that complements structural reforms. Properly designed and implemented reforms of the regulatory and supervisory structure of financial markets raise the resilience of global finance and reduce the likelihood of crises. Such reforms are also key to shaping financial markets that deliver sustainable resource allocation and support economic activity and growth.

Figure 3. Responsiveness to reform and fiscal stance



Additionally, well-functioning financial markets set proper incentives for growth-friendly government reforms, by discounting future gains in the productive capacity into better current financing conditions. In other words, they can help bring forward medium-term effects of structural reforms (Buti, Turrini, van den Noord and Biroli 2009).

Finally, credible strategies of fiscal adjustment and structural reform must allow for interpersonal equity and fairness in the adjustment burdens. Such strategies must furthermore be complemented by a safety net to support the weakest segment of the population. These features are necessary to render such a strategy politically and socially sustainable.

The opportunity for a decisive breakthrough should not be missed

Thanks to effective action in monetary and financial markets, signs of stabilisation in the Eurozone and in the European economy have been increasing lately. This provides a window of opportunity to make a decisive, confidence-injecting breakthrough in resolving the euro crisis. To fully exploit this opportunity, policies must focus on economic growth by implementing structural reforms, at the national and EU level, while continuing to pursue fiscal consolidation at an appropriate pace. Such an approach has the potential to transform a vicious circle of crisis into a virtuous circle of financial stability, stronger growth, and decisive economic adjustment. Europe could move decisively away from the bad equilibrium of low growth and unsustainable debt that it seemed to be approaching in the final part of 2011.

Authors' note: The authors write in a personal capacity. The views expressed do not necessarily reflect the position of the institutions they work for.

References

Buti, M., Röger, W., Turrini, A. (2009), 'Is Lisbon Far From Maastricht? Trade-offs and Complementarities between Fiscal Discipline and Structural Reforms', *CESifo Economic Studies* 55(1).

Buti, M., Turrini, A., van den Noord, P., Biroli, P. (2009), 'Defying the 'Juncker curse': can reformist governments be re-elected?, Empirica 36(1).

Cacciatore, M., Duval, R., Fiori, G. (2012), 'Short-term pain or gain? A DGSE model-based analysis of the short-term effects of structural reforms in labour and product markets', OECD Economics Department Working Papers, forthcoming.

European Banking Authority (2012), 'The EBA's Board of Supervisors makes its first aggregate assessment of banks' capital plans', available at http://www.eba.europa.eu/News--Communications/Year/2012/The-EBAs-Board-of-Supervisors-makes-its-first-agg.aspx.

European Commission (2011), 'A roadmap to stability and growth', COM(2011) 669 final, 12 October 2011.

European Commission (2012), 'Alert Mechanism Report - Report prepared in accordance with Articles 3 and 4 of the Regulation on the prevention and correction of macro-economic imbalances' available at http://ec.europa.eu/economy_finance/economic_governance/documents/alert_mechanism_report_2012_en.pdf.

European Council (2011), 'Euro Summit Statemen't, 26 October 2011, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf.

OECD (2012), 'Going for Growth', OCED Publications, Paris.

Padoan, P. C., Sila, U., van den Noord, P. (2012), 'A dual equilibrium model for public debt and growth', forthcoming.

Marco Buti, educated at the Universities of Florence and Oxford, joined the European Commission in 1987. He was economic advisor of the Commission President until 2003; from September 2003 to August 2006 he was Director of Economies of Member States at the Directorate-General for Economic and Financial Affairs where, as from December 2008, he has been appointed Director General. He has been visiting professor at the Université Libre de Bruxelles, the University of Florence and at the European University Institute. He has published extensively on EMU, macroeconomic policies, welfare state reforms, European unemployment.

Pier Carlo Padoan is Chief Economist and Deputy Secretary-General of the OECD. Prior to joining the OECD, he was Professor of Economics at the University La Sapienza of Rome and Director of the Fondazione Italianieuropei. From 2001 to 2005, he was the Italian Executive Director at the International Monetary Fund, where he was also in charge of European Coordination. From 1998 to 2001, he served as Economic Adviser to the Italian Prime Ministers, Massimo D'Alema and Giuliano Amato, in charge of international economic policies. He was responsible for coordinating the Italian position in the Agenda 2000 negotiations for the EU budget, Lisbon Agenda, European Council, bilateral meetings, and G8 Summits.

Pier Carlo Padoan has a degree in Economics from the University of Rome and has held various academic positions in Italian and foreign universities, including at the University of Rome, College of Europe (Bruges and Warsaw), Université Libre de Bruxelles, University of Urbino, Universidad de la Plata, and University of Tokyo. He has published widely in international academic journals and is the author and editor of several books.

The **Centre for Economic Policy Research**, founded in 1983, is a network of over 700 researchers based mainly in universities throughout Europe, who collaborate through the Centre in research and its dissemination. The Centre's goal is to promote research excellence and policy relevance in European economics. CEPR Research Fellows and Affiliates are based in over 237 different institutions in 28 countries. Because it draws on such a large network of researchers, CEPR is able to produce a wide range of research which not only addresses key policy issues, but also reflects a broad spectrum of individual viewpoints and perspectives. CEPR has made key contributions to a wide range of European and global policy issues for over two decades. CEPR research may include views on policy, but the Executive Committee of the Centre does not give prior review to its publications, and the Centre takes no institutional policy positions. The opinions expressed in this paper are those of the author and not necessarily those of the Centre for Economic Policy Research.