



# **The euro in the storm What have we learned?**

***Conference "Regionalism and Reform of the Global  
Monetary & Financial System: What Role for Europe and  
Asia?"***

***Brussels, 4 February 2010***

**Jean Pisani-Ferry**

Copyright rests with the author



## **Alternative views**

- **The euro as a shelter: it would have been much worse without it**
- **The euro in danger: the crisis reveals fault lines in the design of Economic and Monetary Union**



# Outline

- **Pre-crisis EMU: where we stood**
  - Principles
  - Surveillance and crisis prevention
- **Crisis management: an early assessment**
  - Banking crises
  - Fiscal coordination
  - International cooperation
  - Assistance to countries in crisis within euro area
- **Lessons**



- **Pre-crisis EMU: where we stood**
  - Principles
  - Surveillance and crisis prevention
- **Crisis management: an early assessment**
  - Banking crises
  - Fiscal coordination
  - International cooperation
  - Assistance to countries in crisis within euro area
- **Lessons**



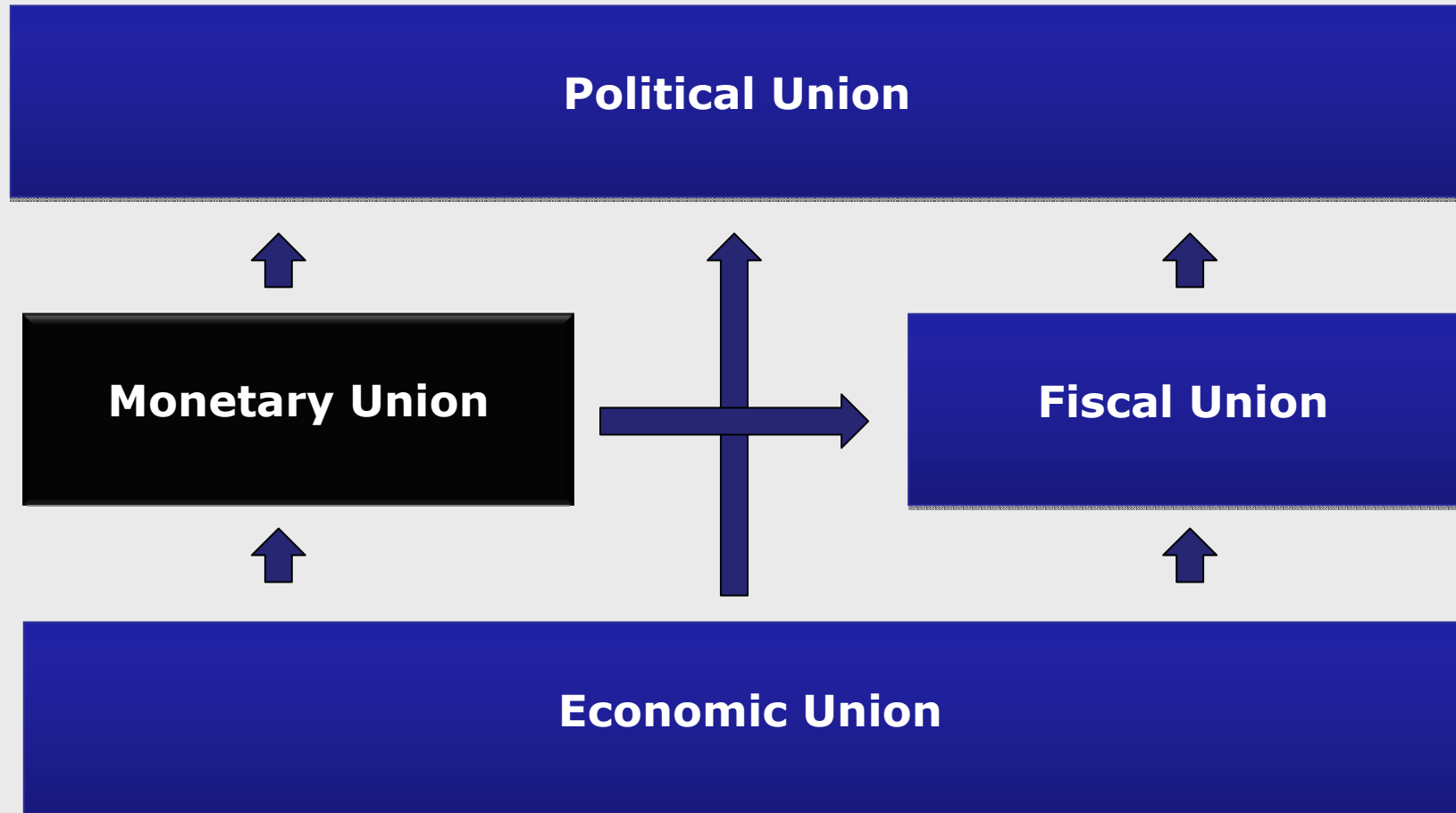
# Principles

## A long road

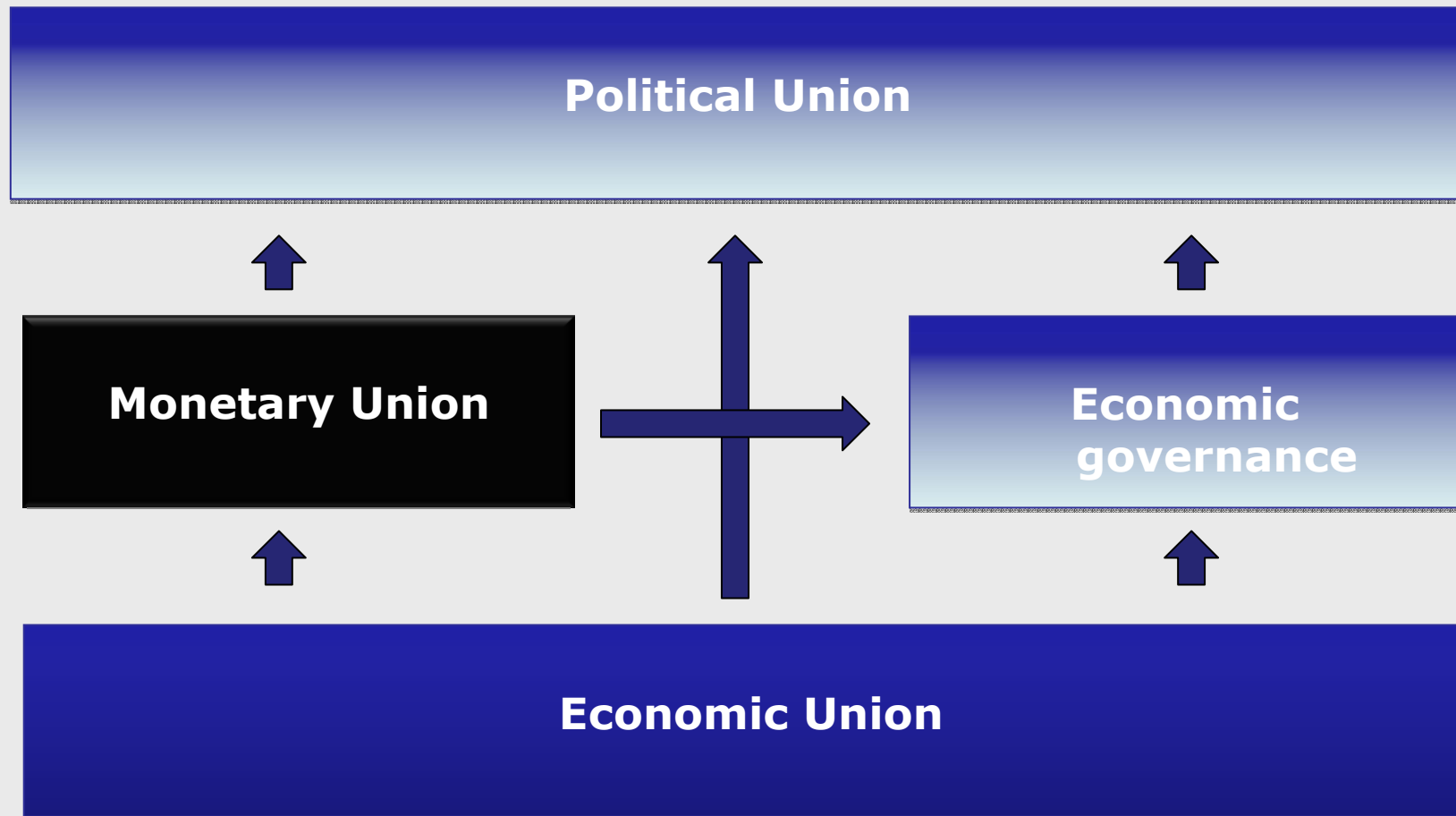
- **1969: Heads of state agree to start making plans for Economic and Monetary Union**
- **1979: Creation of the European Monetary System**
- **1989: Blueprint for Economic and Monetary Union in Europe approved**
- **1999: Launch of the euro**
- **2007-: Lessons learned in the crisis**

**Views on principles of EMU have changed along the road**

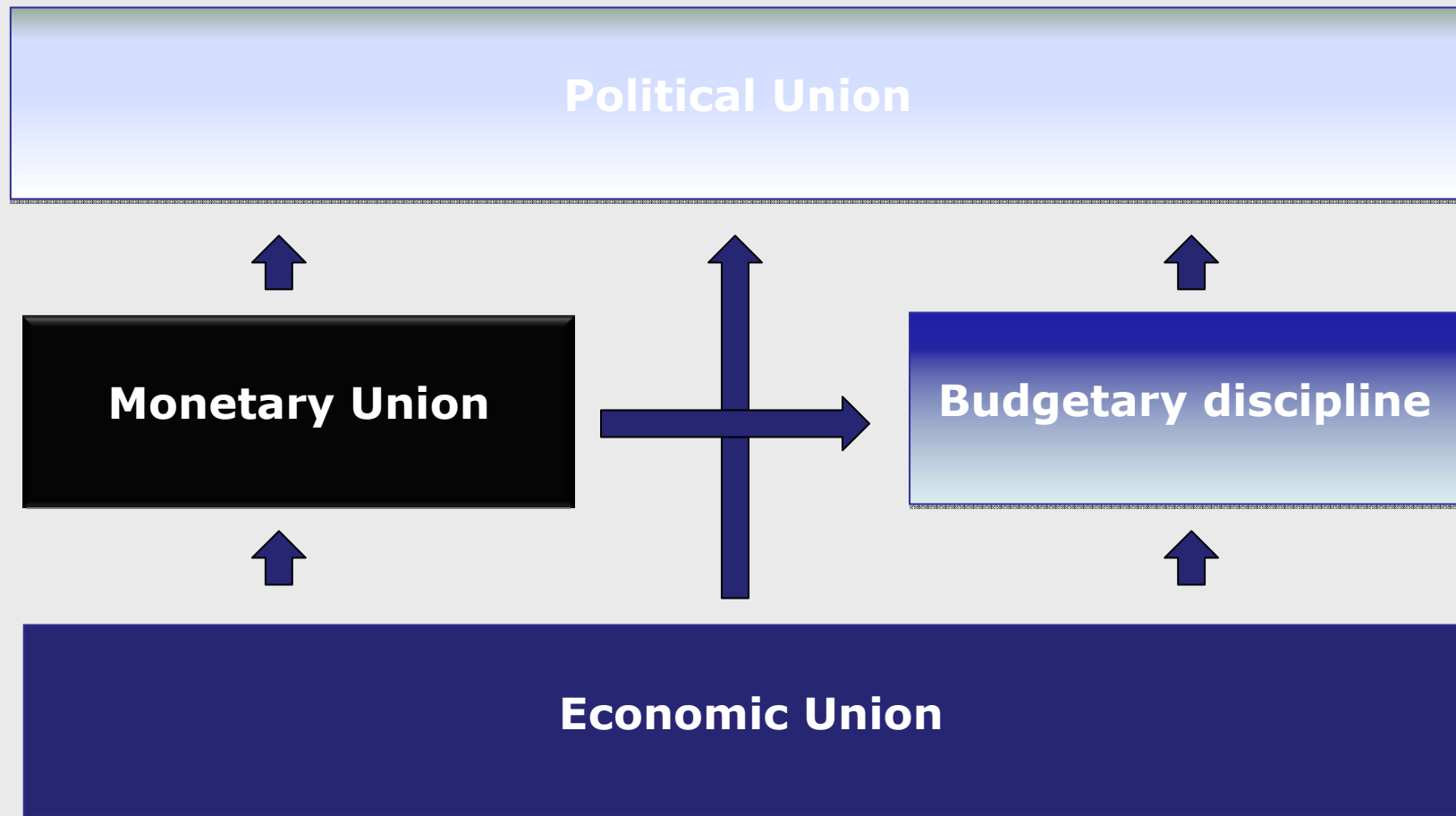
# Economic and Monetary Union: The early view



# Economic and Monetary Union: The 1990s view



# Economic and Monetary Union: The 2000s view





## Implications

- **The crisis hit at a time when euro area partners have limited appetite for deeper integration and solidarity**
- **It is a test of the robustness of a 'bare-bones EMU' which is not embedded in a broader integration project**
- **Of interest therefore for the rest of the world**



## Surveillance and crisis prevention

- **Surveillance essentially targeted at fiscal indicators**
  - Country-by-country approach
  - Use of uniform benchmarks (debt/deficit thresholds)
- **No clear role for credit growth, current account deficits, relative price developments**
  - Were part of overall surveillance exercise but without teeth
  - Furthermore no clear policy framework to decide on need for action, nature of adequate response
  - Early attempt (in 2001) to prompt corrective action by Ireland rebuffed by Irish government
  - Thereafter discussions on Spain, and other countries, but no formal recommendations for action
- **Summing up surveillance has remained too narrowly focused on budgetary indicators**



# Implications for crisis management

- **EMU based on the assumption that effective surveillance would prevent crises**
- **Therefore insufficient crisis management provisions:**
  - Lender of Last Resort role of central bank left unclear
  - Fuzzy provisions for banking crisis management
  - Weak provisions for coordinated budgetary stimulus
  - No mechanism for assisting countries within euro area
- **Why?**
  - Fear of moral hazard
  - Turf war between EU and member countries
  - Genuine confidence in market stability



- **Pre-crisis EMU: where we stood**
  - Principles
  - Surveillance and crisis prevention
- **Crisis management: an early assessment**
  - Banking crises
  - Fiscal coordination
  - International cooperation
  - Assistance to countries in crisis within euro area
- **Lessons**

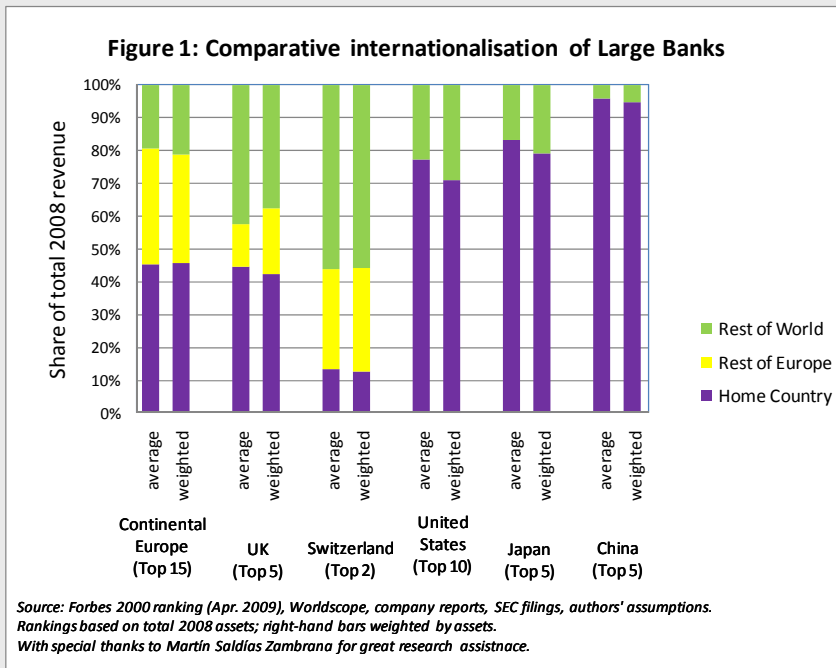


# Banking crises

## Pre-crisis state of play

Significant market integration..

.. but limited policy integration



	National	Currency area	EU	Global
Regulation (CAR..)				
Supervision				
Deposit insurance				
Liquidity provision				
Rescue/restructuring				



## Some modest attempts for improvement

- **Developed over the years as partial responses**
  - Non-binding MoUs that give «a set of principles and procedures for sharing information, views and assessments »
- **But did not elicit much confidence prior to the crisis**
  - “in the event of a crisis involving a pan-European institution or a local crisis having systemic implications, the coordination problems faced by EMU authorities are likely to be greater than those faced before” (Prati and Schinasi 1999)
  - «Suboptimal » institutional set-up « for crisis prevention (and potentially also crisis management) » (Lamfalussy, 2004)
- **EFC crisis simulation exercise in April 2006**
  - Tests of approaches to crisis resolution points to clear potential problems



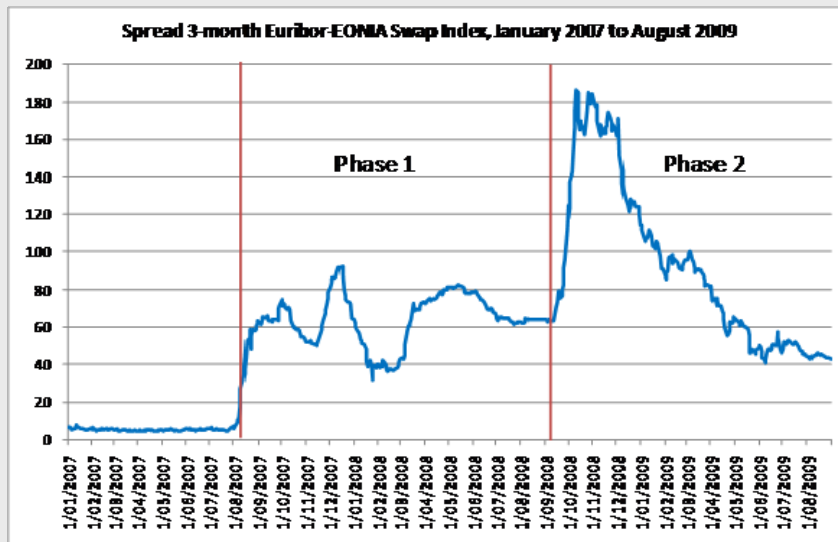
## **Why so little?**

- **Hope that crises would wait until integration is completed**
- **National champions / regulatory capture**
- **Fear of potential budgetary consequences**
- **Regulatory turf war**



# How problems were addressed

## Two phases of the crisis



### Phase 1

- Effective liquidity provision by ECB
- Little progress towards crisis management framework
- Rejection of financial solidarity

### Phase 2

- Agreement on common principles for banking crisis management
- Coordination on guarantees, conditions of recapitalisation, treatment of impaired assets
- Agreement on strengthening of supervision, creation of macroprudential framework



## Summing up

- **Events confirmed weakness of crisis management framework**
- **Performance was better than expected as ad-hoc coordination avoided systemic casualties**
- **Some progress on supervisory framework**
- **But problems remain:**
  - Information-sharing among supervisors
  - Division of responsibility between home country (responsible for supervision of banking entities) and host country
  - Supervision of pan-European banks
  - Resolution of crisis affecting pan-European banks



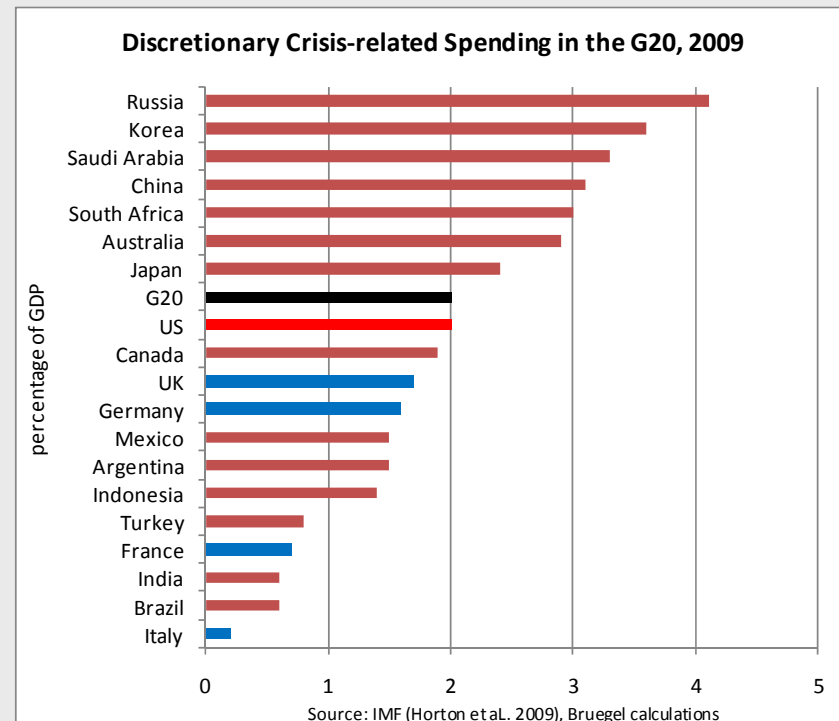
## **Fiscal coordination**

### **Some joint support**

**Legal basis: weak provisions for coordinated stimulus**

- **Focus on prevention, not promotion of deficits**
- **Provisions for coordination essentially non-binding**
- **Were not used in 2008, rather reliance on ad-hoc coordination**

**Delivery: uneven, but not negligible stimulus**





## International cooperation

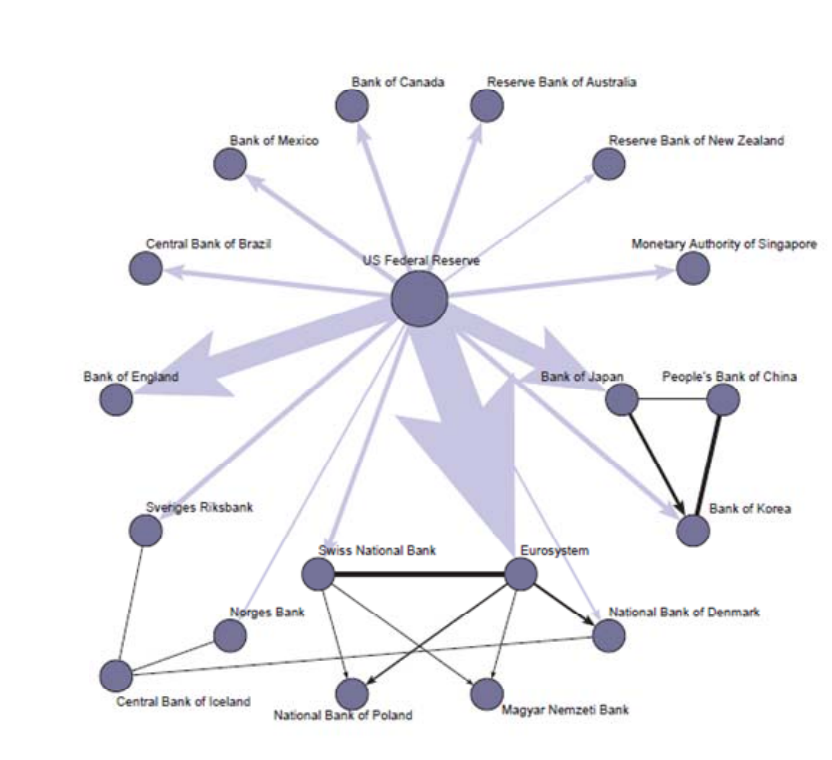
- **Crisis highlighted need for international cooperation**
  - Within G20
  - Among major central banks
  - With neighbouring countries
- **An important test for the euro system**
  - Global responsibilities
  - Regional responsibilities



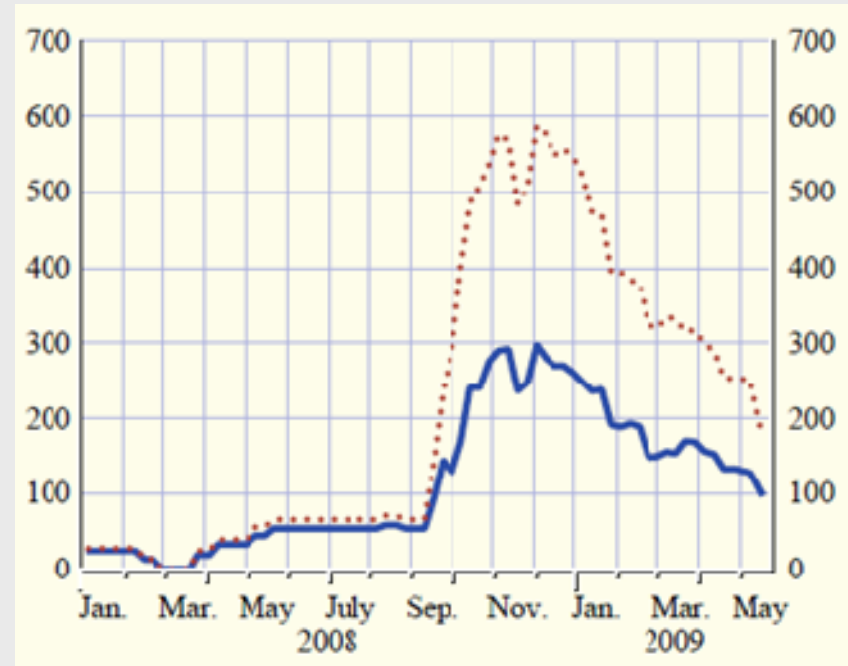
# Global cooperation among central banks: Unprecedented volume of swaps

## Global web of swap agreements

Central bank network of swap lines



## US dollars provided through swap lines by Fed and ECB





## European swaps

- The crisis resulted in euro liquidity shortages in the partially euro-ised countries of Central and Eastern Europe
- However the ECB did not directly provide euros to their central banks, rather entered into indirect euro provision through swap agreements with third countries
- Had no official mandate to take up regional responsibilities beyond



# Agreements between central banks in Europe

	Fed	ECB	Swiss	Swed	Den	Nor
Fed		Swap				
ECB	Swap			Swap		
UK	Swap					
Swiss	Swap	Swap				
Swed	Swap	Swap				
Den	Swap	Swap + ERM2 facility				
Nor	Swap					
Pl		Euro repo	Euro/SF swap			
Hu		Euro repo	Euro/SF swap			
Lat		ERM2 facility		Euro/lat swap	Euro/lat swap	
EE		ERM2 facility		SKN/ZSK swap		
Lit		ERM2 facility				
Isl				Euro/ISK swap	Euro/ISK swap	Euro/ISK swap

Column: provider of liquidity; Row: recipient



## **Assistance to countries in crisis: confusing situation**

- **The EU can provide balance-of-payments assistance to a member state in difficulty (Art 143 of the Treaty)**
  - Has been able to provide effective assistance to Hungary, Latvia and Romania, jointly with IMF
  - ‘Vienna initiative’ has also helped foster rollover of credit to CEECs
- **But this provision does not apply to euro members, e.g. Greece**
- **Rationale:**
  - Exchange rate crises excluded in the monetary union
  - Fiscal crises are possible but leaving open the possibility of assistance would have created moral hazard
- **At the same time EU leaders regard are very reluctant to IMF intervention within the euro area**
- **How the situation will be dealt with will set major precedent for the future**



## EU assistance to non-euro member states

Provider of the loan	Recipient of the loan			Total for these three countries
	Hungary, Oct-Nov 2008	Latvia, Dec 2008 - Jan 2009	Romania, April-May 2009	
EU	6.5	3.1	5.0	14.6
IMF	12.5	1.7	13.0	27.2
World Bank	1.0	0.4	1.0	2.4
Sweden, Denmark, Finland, Estonia and Norway		1.9		1.9
EBRD, Czech Rep and Poland		0.4		0.4
EBRD and EIB			1.0	1.0
<b>Total</b>	<b>20.0</b>	<b>7.5</b>	<b>20.0</b>	<b>47.5</b>
Total (% of 2008 GDP)	19%	32%	15%	18%
EU loans (% of IMF loans)	52.0%	182.4%	38.6%	53.8%



- **Pre-crisis EMU: where we stood**
  - Principles
  - Surveillance and crisis prevention
- **Crisis management: an early assessment**
  - Banking crises
  - Fiscal coordination
  - International cooperation
  - Assistance to countries in crisis within euro area
- **Lessons**



## Lessons

- Euro has passed the crisis test without major damage but combination of insufficient/inadequate crisis prevention mechanisms and weak crisis management mechanisms remains a handicap
- Results from:
  - Difficulty to agree ex ante on desirable course of action
  - Degrees of centralisation and discretion required in a crisis (fair weather vs. stormy weather governance)
- Nevertheless 2007-2009 crisis management has been better than feared by many:
  - ECB has performed well (but for regional initiatives)
  - Governments have been able to agree in extremis
  - EU mechanisms have been used to ensure minimum consistency



## Lessons (2)

- **Looking ahead, major challenge is how to deal with the aftermath of the crisis in specific countries**
- **EMU set-up incomplete in this respect**
  - Lack of clearly defined responsibility for promoting stability in the wider European region
  - Lack of crisis management mechanisms in the euro area
- **Emphasis now on risks within the euro area. Solution will emerge from experience, likely to have effects beyond Greece**