

Assessment and recommendations

The crisis is the first major test of the resilience of the euro area

Euro area countries have experienced their most severe recession of the post-war era, alongside other OECD economies, followed by a sovereign debt crisis in some euro area countries. This has been the first major test of the resilience of the euro area since monetary union. The end of a prolonged global credit and asset price boom around mid-2007 led to turmoil in interbank markets, which intensified into a full-blown international financial crisis from September 2008 after the failure of Lehman Brothers. World trade dropped sharply and there was a rapid retrenchment of private consumption and investment, exacerbated by low confidence and financial sector weakness. Unemployment has increased significantly, although a substantial fall in average hours worked helped to accommodate the weakness of labour demand. While headline inflation rates have been volatile, underlying inflationary pressures have weakened as the result of the scale of economic slack.

The euro area in aggregate avoided some of the largest excesses of the global credit cycle and proved fairly resilient in the downturn. Liquidity provision from the European Central Bank (ECB) responded swiftly to the financial turmoil and the ECB's balance sheet expanded substantially. Temporary government interventions through guarantees and other measures further helped to prevent a more dramatic contraction of bank credit, at the cost of shifting the burden from private debt holders to tax payers. Monetary policy rates were rapidly reduced. Governments further supported demand through discretionary fiscal expansion and allowing a considerable deterioration in the budget balance as revenues contracted, although fiscal policy was constrained in some countries by the weak position of the public finances and rising credit spreads.

However, in some individual euro area countries, there was a large build-up of economic, financial and fiscal imbalances during the upswing. Policies and markets failed to stabilise the range of shocks acting on different economies. Imbalances led to the misallocation of resources and increased the vulnerability of some deficit economies to a future downturn. Weak policy settings and structural problems in some cases exacerbated these pressures.

Recovery is now underway but will be muted

Financial conditions are improving and activity has picked up. A gradual and sustained recovery in underlying activity is now underway. This has been supported by considerable policy stimulus. Consumption and investment have begun to expand. Nevertheless, the

pace of recovery is likely to be muted as the result of on-going private sector balance sheet rebuilding in the wake of the crisis. While expansion in economic activity in some countries has been faster than had been expected earlier in the year, adjustment to marked macroeconomic and financial imbalances in other countries will weigh on the aggregate performance of the euro area. Fiscal consolidation is essential and will increase confidence, although it may dampen the recovery in the short run. Meanwhile, the crisis is likely to have reduced the level of potential output through a lower capital stock, a weakening of the labour market and higher risk premia. This will further constrain the scope for recovery. Excess capacity is nevertheless likely to remain high for some time, restraining inflationary pressures. *As soon as upside risks to price stability in the medium term emerge, monetary policy stimulus should be withdrawn. This would contribute to avoiding distortions created by low interest rates relative to long-run norms. Non-standard measures should continue to be wound down in line with improvements in the monetary policy transmission mechanism.* Substantial risks remain around the recovery and it is crucial that the banking system is returned to good health to support growth. Structural reforms in labour and product markets would facilitate economic adjustment and will be particularly important for achieving vigorous growth in the coming years.

Large-scale government intervention supported the banking system

Government balance sheets have been leveraged to shore up the financial system, as well as to support demand. Deposit guarantees were increased to maintain and reinforce depositors' confidence in the financial system. State guarantees of other bank liabilities have been widespread with countries adopting their own schemes along co-ordinated EU policy orientations based on the common state aid rules. Some countries had to recapitalise banks to prevent the meltdown of their financial systems. In the early days of the crisis, financial rescue packages had to be implemented very quickly. Initial reactions were thus fragmented and bailed out debt holders. Few countries have developed a comprehensive approach to deal with weaknesses in the banking system. *Policy support to the financial system should continue to be unwound as global and local conditions allow, but further recapitalisation of banks could be necessary. All countries should have a full set of effective, credible and harmonised bank resolution tools.* There have been two EU-wide stress tests of banks. The 2010 stress test was particularly important in addressing uncertainties regarding some financial systems and has contributed to greater financial stability. *Stress tests should become a regular exercise and be further harmonised.*

Fiscal policy helped to cushion the downturn but the public finances are now in poor shape

A sharp increase in government borrowing helped to stabilise activity, largely through the automatic stabilisers and discretionary fiscal stimulus measures. In the wake of the crisis, many euro area countries have large deficits and rising public debt. Revenues have fallen due to the economic slowdown and in some countries the collapse of tax receipts related to the credit and housing cycles, while public expenditure has increased. In some countries, there have also been substantial costs related to supporting the financial system. At the same time, credit spreads on government debt have increased sharply for

some countries. *Fiscal consolidation is the immediate priority to stabilise the public finances and should begin by 2011 at the latest in all countries. Consolidation is already underway in some places but credible and detailed medium-term plans need to be set out for all countries. Strengthening the fiscal institutions would help to increase credibility. Reducing deficits to stabilise debt-to-GDP ratios would nevertheless leave indebtedness at a high level by historical comparison, further reducing the margin for manoeuvre in the face of future ageing costs and possible downturns. Prolonged consolidation is thus required in most countries to reduce the debt-to-GDP ratio to prudent levels.*

Monetary policy has provided stimulus

The swift reduction in the policy rate, starting in autumn 2008, eased financing conditions and supported activity in the context of weakening inflationary pressures. Policy rates are lower than during the previous downturn, although long-term interest rates are at a similar level. The potential disruption to the normal functioning of monetary policy transmission was addressed by the adoption of non-standard measures. The increased average maturity of refinancing operations and the shift to full allotment tenders at a fixed interest rate helped to ease market tensions. As a result, overnight market interest rates fell to well below the policy rate. In addition, the ECB provided a US dollar swap line facility and purchased covered bonds for monetary policy purposes. The size of the Eurosystem balance sheet has roughly doubled since the pre-crisis period, mostly related to longer-term repurchase operations that are now gradually being phased out. In May 2010, the Securities Market Programme was introduced to purchase public and private debts with the aim of supporting the monetary policy transmission mechanism through the stabilisation of certain securities markets.

These exceptional measures helped to stabilise the economy during the crisis but lessons should be drawn for the future. The crisis has underlined the destabilising effect that asset and credit cycles can have on activity and inflation. While macroprudential policy should be the primary tool to manage financial cycles, the recent crisis indicates that *consideration should continue to be given to factors that may present risks at medium- to long-term horizons, such as asset prices and balance-sheet growth.* Through the monetary pillar, the ECB already pays close attention to monetary and credit developments. *In this respect, it is essential that monetary analysis continue to be enhanced in order to be effectively and systematically incorporated into the policy process.*

The governance of the euro area could be strengthened

The co-ordination of the response to the crisis has been complicated by the governance arrangements of the euro area with many powers remaining at national level and multiple actors at the EU and euro area levels. The institutional framework was strengthened with the entry into force of the Lisbon Treaty in December 2009, which for the first time recognised the Euro Group and its role in enhancing co-ordination of economic policies. The Lisbon Treaty empowered euro area members of the Council to take formal decisions related to certain euro area matters. With an effective crisis-management framework, the actions of the ECB to fulfil its price stability mandate in crisis situations could be facilitated.

Large imbalances in some euro area countries created problems

Some euro area countries ran large and persistent external imbalances during the upswing. The scale of these savings and investment mismatches appears too large to be explained by economic fundamentals alone and in part reflects underlying economic, financial and sometimes fiscal imbalances at national level. Countries were exposed to a range of divergent underlying pressures, including “catch-up” growth and overly optimistic growth expectations in lower income economies, financial liberalisation, national structural reforms and different demographic pressures. Diverging real interest rates played a destabilising role that contributed to the imbalances. Low real rates sparked strong credit and house price cycles in some economies. With sluggish productivity growth, upwards pressures on wages and prices from booming sectors left competitiveness impaired in some deficit countries. Strong saving and weak investment in some surplus countries, combined with weaknesses in financial regulation, led to funds being channelled to overheating economies. Achieving macroeconomic and financial stabilisation at national level proved difficult in view of the different pressures acting on local economies, together with structural problems and the absence of market discipline. In some cases, fiscal imbalances added to the problem. Large imbalances that appear excessive led to a misallocation of resources, masked underlying economic weaknesses and increased vulnerability. When the financial crisis hit, those countries with large current account deficits were the most exposed and faced the combined pressures of rebuilding of household and corporate balance sheets, impaired financial systems and weak public finances.

Structural measures can help reduce imbalances

Rebalancing economies with large imbalances, both deficits and surpluses, will be a prolonged process. In deficit countries, adjustment will be difficult as prices and wages need to change to restore international competitiveness and to shift resources away from domestically-focussed sectors that grew too big during the boom years. This may require considerable restraint with wages and prices. *Institutional barriers to the required price adjustment should be removed.* Falls in wages and prices cannot be ruled out and in some cases may prove inevitable. *Structural policies have a key role in rebalancing economies.* In deficit countries, reforms can boost productivity and help to bring costs back in line. In surplus countries, structural changes could strengthen domestic demand and enhance productivity growth, notably in the non-tradable sectors.

A cross-cutting approach is needed to avoid harmful imbalances

A new approach to economic and financial management is now required to stabilise national economies, alongside structural reforms to make economies more robust and balanced. The policy framework was not sufficient to prevent the emergence of national economic, financial and fiscal imbalances, and unprepared to deal with the subsequent crisis. In the context of a common monetary policy and single currency, greater differentiation of other policy settings is required to stabilise national economies, and

unsustainable policies at the national level that can lead to spillovers need to be avoided. The new cross-cutting approach should rest on a broad range of policies that can tackle the sources of macroeconomic imbalances, including sound fiscal policies, the development of macroprudential tools and structural reforms. *Wage-setting mechanisms should be more attuned to maintaining competitiveness. Distorting housing market policies that exacerbate housing cycles should be removed. Structural barriers that impede economic adjustment, productivity gains and sustainable growth should be addressed.*

Surveillance and oversight of imbalances should be stepped up

Euro Group and EU surveillance, alongside stronger national frameworks, would help to detect and avoid harmful imbalances. The upgrading of such oversight is already underway and would be further strengthened by current legislative proposals. The focus at European level should be on spillovers between countries, which have largely operated through financial channels. *Surveillance should be based on a wide range of indicators accompanied by a qualitative assessment. This needs to be closely co-ordinated with financial and fiscal monitoring. The availability of comparable and coherent statistics on national developments, particularly in the banking system, should be increased. While monitoring at the EU level gave warnings about imbalances prior to the crisis, these did not lead to corrective action. A graduated procedure needs to be put in place whereby surveillance is intensified as risks to euro stability emerge and the Council issues recommendations and warnings on imbalances that pose significant risks. While identification of harmful imbalances is not straightforward, this should not be a deterrent to setting up a procedure that would help identify, avoid and correct harmful imbalances that jeopardise or threaten to jeopardise the proper functioning of the euro area.*

Fiscal discipline needs to be improved

Weak underlying fiscal positions and trend increases in debt in many countries resulted from a failure to reach sound fiscal positions in line with the SGP in economic good times. In particular, the budgetary stance was too lax in most countries and, in some cases, exceptional revenues from the credit cycle were spent rather than used to strengthen the fiscal position or prepare for future pension costs. Policies were insufficient to achieve sound positions and contributed to excessive imbalances in some cases. Weak fiscal positions limited the budgetary room for manoeuvre during the crisis. Strengthening national and EU-wide fiscal institutions would help to improve budgetary outcomes in the future and reinforce the credibility of current consolidation efforts.

To strengthen market discipline, a credible mechanism for fiscal crisis management is required. Reducing moral hazard and making conditionality a key element are essential features of any future crisis-management framework. For solvent countries facing liquidity pressures, *this should involve a permanent liquidity-support mechanism subject to strong conditionality. If conditionality is not fulfilled, financing support should be withdrawn and the framework should be prepared to deal with this eventuality. Sovereign risk should be fully reflected in financial regulations. The EU programme for Greece should be implemented as planned to achieve the high level of conditionality set out.*

The basic fiscal standards set by the EU Stability and Growth Pact (SGP) should be better enforced to protect euro area economies from weak fiscal positions. EU-level auditing powers have increased. *The monitoring of fiscal positions should be improved, especially in terms of debt and off-balance sheet positions, structural balances and debt management.* The “corrective arm” of the Pact should be enforced systematically by the Council, and *funds should be posted in a non-interest bearing account as soon as an excessive deficit is identified. An appropriate operational definition of the reduction in debt for countries with debt above 60% of GDP should be put in place so that the debt criterion can be applied effectively.* The “preventive arm” of the SGP needs to be enhanced. It should be overhauled so that it provides a system of sanctions applied early in the surveillance process along the lines of current legislative proposals that would be more credible than those currently provided under the SGP. *Sanctions should range from intrusive surveillance and warnings by the Council to financial sanctions. Monetary penalties should include the requirement that funds be posted to an interest-bearing account until corrective policies have been implemented. Sanctions should be applied quasi-automatically by reversing the voting majorities, which would increase the likelihood that analysis and recommendations of the Commission are followed.* These principles are reflected in a package of legislative proposals currently under consideration. *Consideration should be given to other measures to increase the costs of taking fiscal risks through non-compliance with EU fiscal requirements, such as making treatment in financial regulations less favourable.* The creation of the “European Semester” may help to co-ordinate fiscal with other policies and increase the integration with national budgetary processes. *The presentation of Stability Programmes should be further harmonised and based on independent forecasts.*

National fiscal frameworks should be stronger

National governments are ultimately responsible for their public finances. While a more effective Pact is essential to avoiding spillovers from fiscal instability, strengthening national frameworks within the SGP is crucial to achieving more sustainable public finances. *All euro area countries should adopt and abide by broad-based medium-term frameworks for the public finances based on multi-year paths or ceilings for both current and capital expenditures. Going beyond the minimum standards in the proposed EU Directive should be encouraged.* It is important that political will at national level supports the rules and that there is national ownership of the fiscal frameworks. *The establishment of well-designed independent national fiscal councils would be appropriate in many countries in order to set the official forecasts of the public finances and provide analysis and assessment of fiscal policy.* Political commitment to the independence of these institutions is crucial to improve the management of the public finances.

Stronger bank regulations are needed for financial stability

Upgrading regulation, reinforcing supervision and better aligning incentives within the banking sector would increase financial stability in the context of enhanced regulation of the financial sector more broadly. The boom in credit during the upswing was supported by easier bank lending standards, a low level of provisions and the rising leverage of large systemic banking groups. The rapid growth of cross-border banking in the wake of deepening financial integration after the creation of the euro channelled funds from

banking systems with excessive liquidity into overheating economies with housing booms. During the financial crisis, a sharp reduction in cross-border lending added to the difficulties of borrower countries. *Stronger microprudential rules should be implemented in line with the Basel III capital accord, as planned by the EU authorities and as part of a global approach, and on-going EU reform initiatives.* This would include, among other measures, raising the size and quality of capital buffers, and implementing an overall leverage ratio as a backstop. *In addition, liquidity regulations and the risk-weighting system should be strengthened, as well as governance and risk management.* Limits to the integration of EU financial markets, especially in the retail sector, led to large concentrations of risks. *Supervisors should take a more systematic and harmonised view of the geographic concentration of risks when assessing regulatory capital.* Large complex financial institutions were a major conduit for cross-border activities and, by underestimating country and credit risks, became a major source of risk transmission and systemic risk during the crisis. *Consideration should also be given to stronger supervision, additional capital surcharges and levies for systemic institutions.*

Macroprudential policy was generally little used in the run up to the crisis, even as systemic risks built up. Some financial regulations had a pro-cyclical impact. *Both macro- and microprudential supervision should be based on a through-the-cycle approach to risk. Microprudential supervisors should ensure that bank provisioning is forward-looking.* A system of counter-cyclical capital buffers based on a simple numerical rule applied to national credit growth should be introduced as outlined in current EU consultation documents and international proposals. The creation of the European Systemic Risk Board (ESRB) is a welcome development. *It is important that its decision-making is effective and that it plays a full role in achieving macroeconomic stability. EU-wide stress tests should continue to be undertaken on a regular basis and harmonised further.* Given the need to differentiate policies at national level to counter imbalances, *all euro area countries should have appropriate national macroprudential arrangements in place, alongside EU structures.*

Weaknesses in cross-border supervision remain a risk

The system of financial supervision and crisis management remains organised on national lines, reflecting the national fiscal responsibilities, while banking activities are increasingly organised on cross-border basis. Although this has not been the primary problem during the financial crisis, it made it harder to apply consistent and harmonised standards and supervise banks during the upswing. The creation of the European Supervisory Authorities (ESAs) and extension of the system of supervisory colleges to all large cross-border banks is a major achievement. *The fiscal safeguard rules constraining the ESAs' powers should be narrowly applied. A common supervisory database with harmonised definitions of key variables should be created for large cross-border institutions.* A review of the new supervisory arrangements is foreseen after at most three years to determine whether further steps towards more integration are needed and whether a single supervisor would be more fit for the purpose. The burden on banking supervision is increased by the combination of some highly-integrated EU wholesale markets and segmentation in other sectors, which leads to large cross-border banking flows. *Subject to appropriate regulation, remaining obstacles to financial integration should be removed to encourage a more stable banking structure.*

Crisis management has been made more difficult by differences in legal structure across countries and the need to allocate costs. *Burden-sharing agreements should be in place at least for all systemic institutions and legal ring-fencing of assets should be limited where this complicates resolution. Operational arrangements for deposit guarantee schemes should be harmonised and their funding could be switched to an ex ante basis. Bank resolution funds financed by risk-based levies could be introduced.*