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A EUROPEAN EXIT STRATEGY

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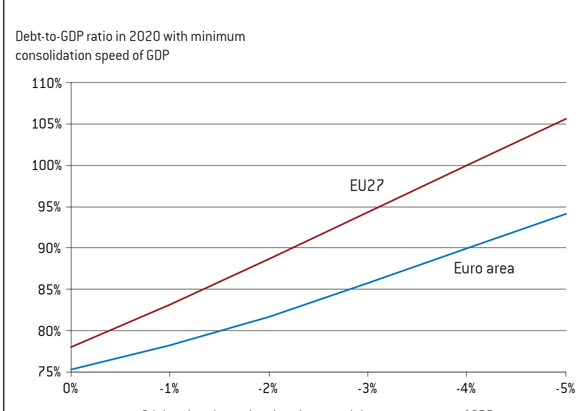
SUMMARY As economic growth resumes, a timely exit from the current crisis mode of unsustainable budgetary, monetary and financial sector policies is needed. Yet, the exit must not be rushed or we risk a relapse into another recession. We propose a sequence of steps towards the exit which should be closely coordinated at European and, where possible, global level over the coming months. Furthermore, in order to ensure that this exit strategy is credible and does not prove to be an empty promise of consolidation, we suggest institutional arrangements within the EU that would provide incentives to follow through.

POLICY CHALLENGE

First, the identification and recapitalisation of ailing banks must be completed urgently, with a clear timetable for the phasing-out of state support. Second, member states should adopt medium-term sustainability budgetary plans in summer 2010 to be implemented from 2011. These plans should detail annual minimum and maximum consolidation objectives as well as a debt target for 2014. Third, monetary policy should remain as supportive as possible. Fourth, given continuing low interest rates, and in order to supervise phasing-in of more stringent financial regulation, the planned European Systemic Risk Board should become operational as early as summer 2010. Finally, to ensure the necessary coordination of the exit between member states and central banks, an ad-hoc reinforced consultation mechanism should be set up at European level for 2.5 years, renewable once.

Projected debt to GDP ratio in 2020 assuming annual consolidation of 0.5% GDP*



* As a function of one-time loss in potential output due to the crisis.
Source: Bruegel simulation, see Figure 4

THE CURRENT BUDGETARY, monetary, and financial-sector policies have been emergency measures to cushion the initial blow of the crisis and to prepare the road to recovery. But these emergency measures are not sustainable in the long run and must be phased out. Finding the right exit strategy is difficult. How fast can and should normalisation take place? How should budgetary, monetary and financial-sector policies be sequenced? And should these steps be coordinated within the euro area, the EU and beyond in order to avoid adverse macroeconomic developments? To complicate matters further, the task is not only to return to the normal state of the economy before the crisis. As a result of the crisis and of the lessons to be learned from it, 'normality' in the future will have to be different from pre-crisis 'business as usual'.

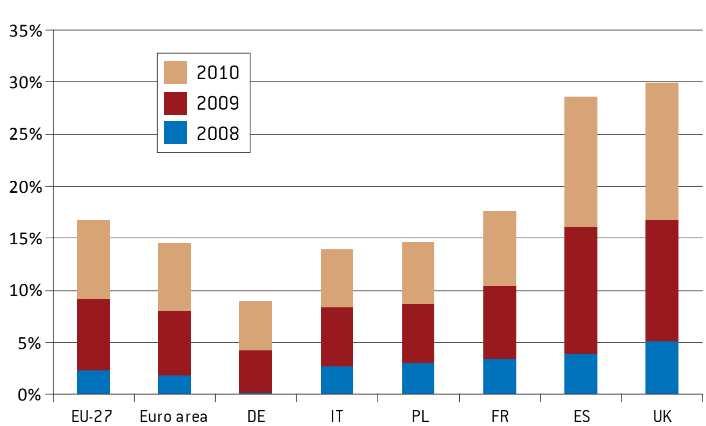
This policy brief addresses these questions and outlines an exit strategy for the EU[1]. The second section looks at the conditions currently confronting us. The third section explores the interdependence of exit policy instruments and what this implies. The fourth section develops a sequenced exit strategy and discusses its implementation. The fifth section summarises the policy recommendations.

THE POST-CRISIS LANDSCAPE

One year after the acute crisis started in Europe, monetary and fiscal policy are operating in crisis mode. The resulting surge in budget deficits (Figure 1) is unprecedented in the EU. As a consequence, the IMF (2009a) projects an increase in the average debt-to-GDP ratio in the euro area of 30 percentage points, to reach 90 percent of GDP by 2014. The average disguises substantial increases for some member states.

Part of the budgetary deterioration is cyclical, but part is permanent. In the years following a shock, *growth rates* often recover to the pre-crisis pace but the loss in *output level* typically remains permanent[2], implying a corresponding lasting shortfall in government revenues. As a result, there will be an increase in the structural budgetary deficit.

Figure 1: Surging deficits in response to the crisis
Cumulative budget deficits 2008-2010 as a percentage of GDP in 2010



Source: IMF (2009b),for Poland: IMF Article IV Report, August 2009.

Monetary policy has brought interest rates down to nearly zero for all major currencies, including the euro. In addition, central-bank efforts to rescue financial systems by giving banks easier access to central-bank money has caused a rapid and signicant expansion, and changes in the composition, of their balance sheets. So far, this policy of 'quantitative' and 'qualitative easing' has not affected the broad money supply and therefore not resulted in inflationary pressures (von Hagen, 2009). But as banking systems recover central banks must keep a keen eye on monetary developments to ensure that inflationary potential does not build up in the future.

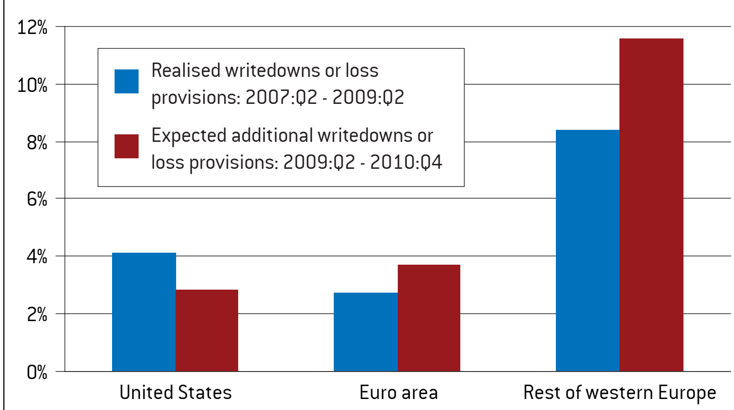
Governments have also supported directly banking systems through guarantee schemes and recapitalisation. These measures have succeeded in restoring some financial stability. However, the most recent estimates of the necessary write-downs in the banking sector (Figure 2) raise the question of if recapitalisation to date has been sufficient. Available evidence (IMF, 2009c) suggests there are significant differences across countries and across banks, which suggests targeted action at national level is still required.

So far, European governments have focused on emergency measures to prevent collapse of the financial system without fully addressing the fundamental issue of undercapitalisation of the banks. Meanwhile banks are borrowing at near-zero interest rates and investing in higher-yielding

1. This Policy Brief summarises and updates a paper prepared at the request of the Swedish EU Council presidency for the ECOFIN Council of 1 October 2009. Research assistance by Martin Kessler is gratefully acknowledged.

2. See for example Cerra and Saxena, 2008, Pisani-Ferry and van Pottelsberghe, 2009, and IMF, 2009b.

Figure 2: Reported and estimated potential write-downs in the bank sector(in percent of GDP)



Source: IMF (2009c). Note: rest of Western Europe includes Denmark, Iceland, Norway, Sweden, Switzerland and the UK.

assets, which is allowing them to regain better profitability and to strengthen their capital base. This process could go on for as long as it takes for them to reach the capital ratios required by regulatory and, perhaps more importantly, market standards. However, in the meantime it involves the risk of relapse into instability in the banking sector and persistent constraints on the supply of credit. In view of this, it would be unwise to undertake the necessary fiscal and monetary policy exit without first addressing the remaining problems of the financial sector.

POLICY INSTRUMENTS AND STRATEGIC INTERDEPENDENCE

An appropriate exit strategy must have at least three broad objectives:

i The restoration of budgetary sustainability,

ii Macroeconomic stability with non-inflationary growth at a pace compatible with elimination of the 'output gap'[3] in the medium term, and

iii Financial stability, which implies both stability of the financial sector without government or central-bank support and the prevention of financial instability in the future.

The pursuit of these exit objectives involves budgetary consolidation, monetary tightening and the withdrawal of guarantees and exceptional liquidity support for banks. Table 1 shows the various policy instruments involved in the subsequent exit discussion.

However, each of these policy actions has both direct and indirect effects that should be taken into account when designing an exit strategy. Table 2 provides a stylised summary of the likely direct and indirect impact of exit

Table 1:
Dimensions of exit from exceptional crisis management measures

		Institutional actor	
		Governments	Central banks
Impact on	Macro	Budgetary consolidation	Monetary tightening (reverse quantitative easing, increase interest rates from near-zero level)
	Banks	Withdrawal of government guarantees for banks; Bank triage, recapitalisation and restructuring	Withdrawal of liquidity support for banking sector; Macroprudential oversight

Note: macro-prudential oversight is categorised here as belonging to central banking because it is assumed that, following European Council decisions in June, it will largely be done by central banks.

Table 2:
Direct and indirect impact of exit policies on exit and other major objectives

(Direct impact in red)		Impact on exit objectives			
		Budgetary sustainability	Macro stability	Financial stability	Potential output
Exit policies	Budgetary consolidation		+	-	+/-
	Monetary tightening	-		-/+	+/-
	Withdrawal of liquidity support	+	-	-	-
	Withdrawal of government guarantees	+	-	-	-
Other policies	Bank recapitalisation and restructuring	-/+	+		+
	Macroprudential oversight	+	+		0

3. The output gap is the difference between potential output and actual output.

policies on the exit and other major policy objectives.

It is instructive to explore these effects in detail, starting with the impact of budgetary consolidation. While its direct impact on budgetary sustainability will normally be positive, budgetary consolidation would tend to reduce economic activity, especially where consolidation relies on increasing tax rates. Such a reduction in economic activity would tend to reduce inflation and negatively affect the health of the financial sector, not least because of increased default risks. Finally, the impact on potential output depends on the quality of the adjustment programme, so it is ambiguous.

The impact of monetary tightening is similar to the impact of budgetary consolidation, so to some extent they can be thought of as substitutes. But there are two important differences. First, while the impact of budgetary consolidation on price stability tends to be positive, the indirect impact of monetary tightening on debt sustainability tends to be negative, both on account of an increased output gap and higher real interest rates on legacy debt. Furthermore, the impact on financial-sector stability of monetary tightening is ambiguous. While monetary tightening tends to reduce financial-sector profitability, thereby increasing the vulnerability of ailing banks, real interest rates close to or even below zero increase the likelihood of disruptive bubbles in asset prices. By reducing the risk of the re-emergence of bubbles, increased interest rates therefore also improve financial stability.

The withdrawal of liquidity support from the banking sector reduces the budgetary and quasi-budgetary exposure to banking risks, thereby helping to improve budgetary sustainability. However, the positive budgetary impact might be inhibited if this very withdrawal increases the risk of financial-sector instability.

So: all core exit policies could therefore negatively impact not only economic activity but also financial-sector stability. This implies a strategic interdependence between these instruments, meaning: simultaneous and vigorous pursuit of all three exit policies might entail a serious risk of a double-dip recession and a renewed crisis in the banking sector.

Fortunately, the risk linked to this strategic interdependence can be mitigated somewhat by the pursuit of complementary policies ('other policies' in Table 2). Bank recapitalisation and restructuring, and macroprudential oversight, are additional instruments for reaching the policy objectives.

DESIGNING AN EXIT STRATEGY

The European Council of 18-19 June concluded that 'there is a clear need for a reliable and credible exit strategy, inter alia by improving the medium-term fiscal framework and through coordinated medium-term economic policies.'

A prerequisite: complete the recapitalisation and restructuring of ailing banks

Identification, recapitalisation and restructuring of ailing banks, not fiscal retrenchment, should be the first step in the exit strategy. Once accomplished in full, it will allow central banks and ministers of finance to pursue their future monetary and budgetary exits without the constant fear of causing renewed bank failures in the process. Furthermore, attending to banks first will boost recovery by making credit more readily available to business and enhancing longer-term growth prospects at the same time.

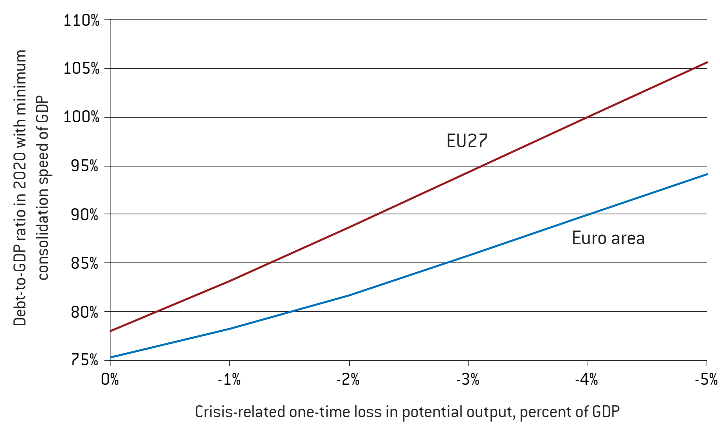
International interdependence is at work here, especially within the euro area: in countries where big banks remain insecure and dependent on exceptional liquidity provision at near-zero interest rates, lack of action by treasuries represents a *de-facto* constraint on the ECB's freedom of action.

But the recommended swift bank recapitalisation is easier said than done. The main difficulty is that it is hard to make the case to electorates angry at the financial sector. It should be argued forcefully that delaying recapitalisation is likely to be even more costly, as the example of Japan illustrates. Also, it should be pointed out that recapitalisation can even be a profitable investment, as was the case in Sweden. In addition, proper incentives for member states not to delay recapitalisation should be provided. First, credible deadlines should be set regarding the phasing out of government guarantees at the European level, using EU state-aid rules to enforce it. Second, central banks may wish to design their exit from bank support measures along a similar timescale. This is possible since there are no compelling reasons to link the timing to that of the other aspects of the monetary exit, especially macroeconomic normalisation (see for example Bini Smaghi (2009), Trichet (2009) and Bernanke (2009)). Third, the requirements of the excessive-deficit procedure should be adapted to accommodate bank recapitalisation. This could be achieved by temporarily calculating the budgetary cost of bank rescue net of the value of the bank shares governments receive in return. Once that arrangement expires, for example in 2014, the return to the usual Maastricht definition of the debt would serve as a welcome incentive not to unduly delay privatisation. Lastly, comprehensive stress-testing and a framework for work-out at the European level would be highly desirable (see Posen and Véron 2009 for a detailed proposal)[4].

The first macro step: budgetary consolidation

Budgetary consolidation should come before monetary tightening, mainly because fiscal policy is the more costly and less nimble stimulus instrument. Besides, delaying consolidation or leaving its pace and duration hanging in the air would involve a non-trivial risk of adverse bond-market reaction. Finally, successful budgetary consolidation will reduce inflationary pressures, thereby allowing central banks to sustain a supportive monetary policy stance for longer and tighten monetary policy only when inflationary potential arises. This sequencing, rather than monetary tightening first and budgetary consolidation second, should be a priority goal in the design of exit strategies.

Figure 3: Projected debt to GDP ratio in 2020 assuming annual consolidation of 0.5% GDP*

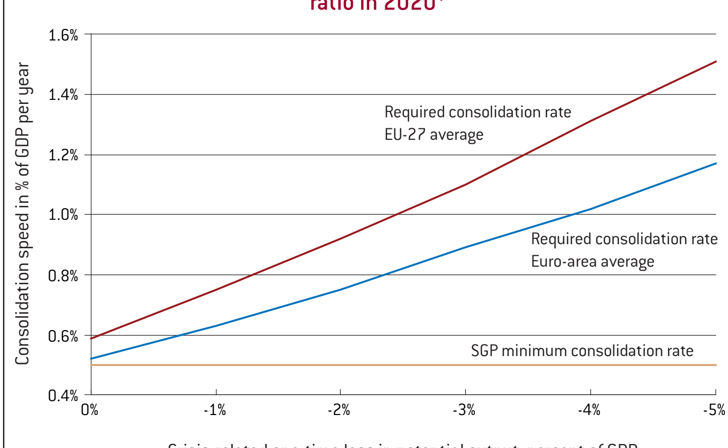


* As a function of one-time loss in potential output due to the crisis. Source: Bruegel simulations, see Box 1 (overleaf).

Figure 3 shows the extent to which the budgetary outlook has worsened during the crisis. According to our simple fiscal simulation, the debt-to-GDP ratio for the EU27 could still stand at 100 percent of GDP in 2020, even assuming a full withdrawal of the stimulus packages in 2011 and a budgetary consolidation rate of 0.5 percent of GDP per annum thereafter, which is the minimum consolidation speed required by the EU's Stability and Growth Pact (SGP). This debt level could be unacceptably high, not least because of the rapidly increasing budgetary cost of ageing populations.

By way of illustration, Figure 4 shows that the annual consolidation speed might have to be significantly above the minimum rate of the SGP if the objective were to achieve a debt-to- GDP ratio of 75 percent on average across the EU. (The challenge of consolidation will be greater still for a number of individual EU countries inside and outside the euro area).

Figure 4: Consolidation rate required to reach a 75 percent debt-to-GDP ratio in 2020*



* As a function of one-time loss in potential output due to the crisis. Source: Bruegel simulations, see Box 1 (overleaf).

4. The stress-test results made public by the CEBS on 1 October 2009 include almost no information on the differing situations across countries and across banks. They therefore fail to provide sufficient guidance.

BOX 2: KEY ASSUMPTIONS OF THE FISCAL SIMULATION

The fiscal simulation underlying Figures 3 and 4 uses the most recent data and forecast of the European Commission's DG ECFIN for the EU27 as a starting point. It then assumes a 1.5 percent growth rate of potential output until 2020, a linear narrowing of the output gap until it reaches zero in 2015, and a real interest rate for public borrowing of 2.5 percent.

On that basis, the evolution of the debt-to-GDP ratio is extrapolated until 2020 as a function of two key parameters: the one-time loss in potential output due to the crisis and the speed of budgetary consolidation. Specifically, a one-time hit to potential output in 2010 varying between 0 percent and 5 percent of potential GDP is considered. The consolidation is modelled assuming that discretionary stimuli are sustained in 2010, fully discontinued in 2011 and as of 2012 varying speeds of consolidation are applied. For example, at a consolidation speed of 0.5 percent of GDP, the primary budgetary position is improved by an additional half percent of GDP every year until the budgetary surplus reaches 1 percent of GDP. After that, the structural expenditure and revenue ratios are kept constant.

From these simulations we can conclude that the budgetary consolidation required will be substantial on average[5]. In order to make this politically delicate and painful process credible and successful, a strong collective commitment is needed at European level over and above the provisions of the SGP. Although the Pact is not the answer to the consolidation challenge, as officials tend to claim, it should not be weakened in the process but rather used as an instrument to achieve sustainability. This is by no means trivial since we are in uncharted territory: today, as many as 20 member states out of 27 find themselves subject to the SGP's excessive-deficit procedure.

The primary focus should be on restoring the sustainability of public finances. The larger the debt ratio, the faster consolidation should be, enforced via medium-term Sustainability Programmes that should be adopted by national parliaments by summer 2010. Reforms that improve public-finance sustainability in the medium run, notably pension reforms, should be taken into account in the setting of budgetary objectives. With these comprehensive programmes, member states should commit to a minimum speed of consolidation and to debt ratio stabilisation by 2014 at the latest.

While budgetary consolidation must be swift, it should not be abrupt. The multiple impact of significant and simultaneous retrenchment in most EU countries (and beyond) is likely to represent an important drag on demand growth. The conditions that in the past allowed some countries to experience painless consolidation are unlikely to be met[6]. Thus, the proposed national Sustainability Programmes should not only provide a minimum but also a maximum envisaged speed of consolidation, and their implementation should be jointly monitored. Implementation could be coordinated by the Eurogroup for the euro area whereas the EU's ECOFIN Council (for EU-wide coordination) and the G20 (for global coordination) should also play their roles.

The credibility of government commitments to sustainable public finances is the key to successful consolidation. We recommend that governments establish Sustainability Councils at the national level with the task of monitoring the development of public finances, advising governments on strategies to reduce debt and giving public comments on, and assessments of, their countries' public finances (see Pisani-Ferry et al., 2008). Countries with more effective institutions or effective fiscal rules and stronger track records should be given more flexibility in implementing their commitments. EU member states should also consult on reforms that can help offset the decline in potential output resulting from the crisis, and strengthen potential output growth in the medium term. They should start to implement these commitments in 2010 and they should be prioritised in the forthcoming update of the Lisbon strategy, the EU's own mid-term economy strategy template.

Monetary policy: arm's-length support

If budgetary policy is given precedence, the implication is that, consistent with central banks' mandates, monetary policy should remain geared to price stability and would normalise once justified by expected price developments[7].

5. This is also the conclusion of Cottarelli and Viñals (2009).

6. These conditions included *inter alia* strong external demand, initially high levels of long-term interest rates (which dropped as a consequence of consolidation), and monetary support (lower interest-rate and exchange-rate depreciation in response to consolidation).

7. In this process of normalisation, central banks should continue their past practice of focusing on second-round effects of increases in world market prices of raw materials and agricultural produce if and when they arise as the global economy starts to pick up again.

Against the background of weak public demand and possibly weak global demand, this may take some time. Hence, policy interest rates may have to remain close to zero for an extended period and unconventional initiatives may for the time being have to remain part of central bankers' toolkit.

However, there is a non-negligible danger that a low interest-rate environment could once again fuel bubbles and recreate the conditions that contributed to the financial excesses of the early 2000s. Already signs have emerged pointing in this direction. In response, a second policy instrument for central banks is needed in addition to the interest rate. We recommend speeding up the creation of the European Systemic Risk Board (ESRB), which the European Council agreed on in June. Ideally, it should be in place by summer 2010. This strengthened macro-prudential supervision framework could be used *inter alia* to help time the phasing in of stricter and anti-cyclical capital buffers for banks, and pre-empt the excessive leveraging that can accompany bubbles.

Another, politically more delicate, concern is the coordination required to achieve the desired sequencing between fiscal and monetary policy. The difficulty is not so much that governments and central banks would find it hard to agree on the principle that budgetary exit should come first and monetary exit later once inflationary pressures are building up again. However, central banks are reluctant formally to engage in any form of *ex-ante* coordination that they might consider at odds with their independence and their mandate. And substantively, central banks focused on inflation might well like rapid budgetary consolidation more than governments with their minds on short-term growth and employment. This could lead to a situation where a government go-slow on budgetary consolidation provokes central banks into a headlong dash for monetary tightening.

Against this background we recommend that, at the technical level, efforts be intensified to form a consensus view between member states and central banks on where potential output currently stands and how it is likely to evolve. And at the political level, budgetary authorities will be well advised to internalise to some extent the often more hawkish exit preferences of the central banks to assure that the desired sequential exit can take place.

Governments and central banks should keep each other abreast of their intended policies and each take into account the plans of the other. In particular, the ECB should be very clear about its views of the situation and explain to governments the conditions under which it would hold interest rates low and the conditions under which it would think that higher interest rates would be more appropriate.

The coordination challenge

Economic policy coordination is controversial in the EU. The need for coordination at this juncture should not be used as a pretext to strengthen it permanently. Any attempt to do so could backfire. It is therefore advisable to establish temporary arrangements for coordination, with a sunset clause. We recommend that EU governments and central banks commit to coordinating exit strategies and set up under Article 100 (1) of the Treaty a temporary (say two and a half years, renewable once) reinforced consultation mechanism. This should commit governments to *ex-ante* consultation with the Commission and partners on all aspects of exit strategies and should include a joint political commitment to make use of country-specific recommendations in the case of departure from the commonly agreed strategy.

With such a temporary EU coordination framework in place, it will also be easier to develop 'cooperative and coordinated exit strategies' at the global level as called for at the Pittsburgh G20 summit[8]. G20 cooperation would need to include discussion of exchange-rate developments, in particular with the US and China.

SUMMARY OF RECOMMENDATIONS

On the basis of the above analysis, we recommend the following:

1. In recognition of the exceptional character of the situation, EU governments and central banks should commit to **coordinating exit strategies and set up a reinforced consultation mechanism** to this effect.
2. **Bank recapitalisation and restructuring should be completed in all EU countries urgently**. Until the end of 2014, assessments of member states' budgetary situations and budgetary consolidation plans should be

8. 24-25 September 2009, see http://www.pittsburghg20.org

made on the basis of gross government debt *net of the value of bank capital held by the government*, instead of gross debt. Firm deadlines should be set for the termination of government guarantees.

3. **Budgetary consolidation should start in 2011** with the withdrawal of the stimulus and continue at a steady pace under a 'European Sustainability Programme' covering 2010-2015. In accordance with this programme, each government should present to its parliament by summer 2010 a medium-term budgetary plan, including a debt target for end-2014, and annual minimum and maximum consolidation objectives.
4. **The proposed European Sustainability Programme should be enforced through the SGP**. This may require technical amendments to SGP procedures to accommodate the timetable for the exit after such a severe crisis. Governments should also be encouraged to strengthen their budgetary institutions, including through the establishment of independent Sustainability Councils.
5. **Central banks**, especially the ECB, **should resist the temptation of premature tightening**. Timely budgetary retrenchment and post-crisis adjustments in the private sector will weaken aggregate demand, creating more room for monetary policy without increasing inflationary pressures, though central banks should be ready to increase interest rates to deal with potential inflationary threats.
6. To avoid the build-up of financial instability in the context of exceptionally low short-term interest rates, **preparations for the creation of the European Systemic Risk Board**, and for the definition of a macroprudential policy framework, **should speed up** with a view to being operational by summer 2010.

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