EUROPE

Europe Under Stress

The global economic crisis is testing the cohesion of the European Union

Marek Belka

THE global financial crisis has jolted Europe's historic journey toward "an ever closer union." For many years, the great European project progressed smoothly, adding new members, eliminating the barriers that divide its people, and delivering greater prosperity. This crisis is its first major test, revealing framework flaws that the good years had covered up. Although national and regional responses to the crisis have grown more coordinated over time, it is still too little and too late. Will European institutions and policymakers be able to respond and adapt to keep moving toward "more Europe" or will the result be "less Europe," or indeed "many Europes"? The choices made during this crisis will shape Europe's destiny for the foreseeable future. The problems differ in the west and in the east, but many, indeed the most important, challenges must be tackled jointly.

Financial to-do list

Advanced Europe is experiencing the worst recession since World War II. Decisive and unprecedented policy action has helped prevent an outright meltdown of the financial sector and even more brutal consequences for output, but the outlook is still bleak and the eventual recovery will likely be tepid and fragile. Beyond the immediate need for crisis management, Europe must revisit the frameworks on which it is based, because many have been revealed to be flawed or missing.

Most pressing is ***the need to overhaul the European Union's financial stability framework***. This is critical to prevent future financial crises and to minimize the costs when they happen. Although policymakers have generally reacted swiftly to crises, countries have often pursued different solutions to similar problems, causing difficulties for others.

Deposit guarantees are a case in point. Prompted by the crisis, many countries increased their guarantees, with some moving cautiously and others deciding to provide unlimited coverage. This distorted competition affected deposit allocations and led to cross-border tensions between policymakers—most important, however, it undermined public confidence in the European crisis response. And although attempts have been made to address these issues, more needs to be done. For instance, the agreement on deposit insurance specifies a minimum level but not a maximum, which would help address competition issues.

Europe's regulatory and supervisory frameworks have lagged financial market integration. The current framework, while slowly evolving toward a more European solution, is ill equipped to adequately anticipate systemic risks. Preventing

Girl walking past a shop window in Riga.

Europe's financial markets from splitting up along national boundaries requires "more Europe," especially in terms of regulating, supervising, and agreements on sharing the costs of supporting cross-border institutions.

Another lesson from the crisis is that ***there is an urgent need to establish Europewide macroprudential oversight*** to avoid the kind of boom and bust cycle that is afflicting the global economy now. The recent proposal by the European Commission—based on a report prepared by former IMF Managing Director Jacques de Larosière—would be an important step toward meeting these goals, but much more is ultimately needed.

More immediately, ***Europe's financial system needs to make more rapid and better coordinated progress on loss recognition, ring-fencing legacy assets, stress testing, and recapitalizing viable institutions*** while resolving others. Without such measures to restore the health of the financial sector, the macroeconomic effect of the support provided by governments and central banks across the region will be stymied.

Euro area under pressure

The crisis has exacerbated strains within the euro area. Many of the euro area's 16 member countries have been running large current account and fiscal deficits, coupled with anemic growth and high debt ratios. These countries are now suffering from more difficult financing conditions and even worse growth prospects. This has prompted some analysts to question whether the euro area can stay together, and others to call for greater "solidarity," such as issuing euro area bonds for national financing or greater federal fiscal powers. These are complex and sensitive issues, but if they are not tackled, they could become highly disruptive.

Reinvigorated structural reform would ease these strains and help Europe confront growing social pressures in the wake of the crisis. In the context of the European Union's Lisbon Agenda for improving competitiveness, Europe has made important progress in liberalizing and opening its markets, resulting in increased productivity and employment. But progress has slowed in recent years. This is particularly unfortunate, because the crisis threatens to undermine future growth by forcing people out of the labor market and dampening private investment. What is needed is a second generation of structural reforms to reinvigorate Europe's economies.

Crises sometimes weaken politicians' resolve, but they can also be a call to arms and provide an opportunity to overcome old obstacles. Consider the comprehensive reforms in Italy after the 1992–93 Exchange Rate Mechanism (ERM) crisis, the shake-up in the United Kingdom after the "winter of discontent" in the late 1970s, and the reform drive in Ireland and the Netherlands in the early 1980s following macroeconomic deterioration and global supply shocks.

High on the agenda now should be increasing competition in still-protected sectors and making labor markets more flexible and less divided between well-protected insiders on permanent contracts and vulnerable outsiders on temporary contracts. Both theory and experience show these reforms work best if implemented simultaneously, with labor benefiting from lower prices, firms from lower costs, and government accounts from faster growth and higher tax revenues.

Balancing the budget

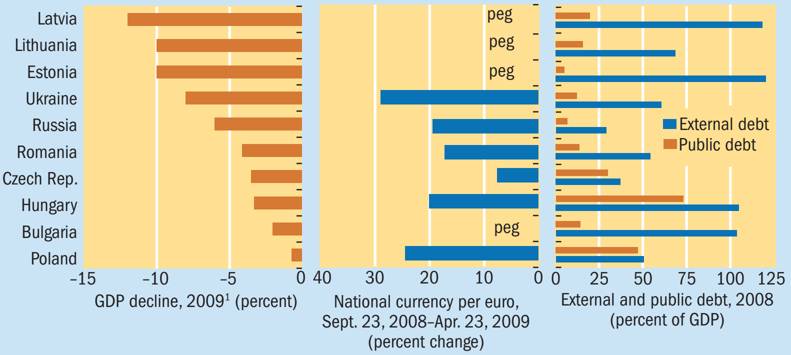
The cost of the recession, the fiscal stimulus applied to beat it, and the support given to the financial system, highlight ***the need to strengthen Europe's fiscal framework***. Although the Stability and Growth Pact (which imposes a ceiling on budget deficits) and national fiscal rules have fostered some improvement in fiscal positions, it has not been enough. Going into this crisis, some 10 years after the euro's introduction, too many countries were too far away from balanced budgets and moderate debt levels. Coming out of the crisis, these ratios will rise to alarmingly high levels. With financial markets set to scrutinize fiscal performance once again, potential growth expected to fall, and population aging to intensify, Europe's public finances need to improve quickly and in a lasting fashion so that it will be able to weather future crises. This can really be achieved only through political will, but changing the fiscal framework could help. An important step in this direction would be to make medium-term deficit and debt targets more binding and macroeconomic projections more realistic.

From boom to bust

Emerging Europe is also in deep crisis. The region has evolved rapidly since the breakup of the Soviet Union, with ever closer financial and trade links with advanced Europe bringing about growth and income convergence. But this integration, especially the region's heavy reliance on capital inflows, has also made it more vulnerable (see chart).

Varied picture

Countries in central and eastern Europe have been affected very differently by the crisis.



Source: IMF.
[1]Forecast as of April 2009, World Economic Outlook database.

The apparent ability of new EU members to attract cheaper funding, the so-called halo effect (see "Losing Their Halo," in this issue), has disappeared. Gone too is the notion that bank-based external financing will guarantee more stable capital inflows. Countries with higher inflation and current account deficits or those that funded a credit boom by taking cross-border loans are suffering the most. And the recovery will depend not only on making the right policy choices at home, but also on developments and choices made in the rest of Europe.

In the short run, ***macroeconomic policies should reflect the fact that Europe, from east to west, increasingly acts like one economy***. Sharing the benefits of integrated markets goes hand in hand with sharing the shocks that affect others and now reverberate through feedback loops of trade, financial markets, and cross-border banks. For instance, deflating credit markets in emerging Europe now affect advanced economies through the exposure of parent banks and the trade repercussions caused by possible exchange rate volatility. This calls for coordination of macroeconomic policies, but also for more specific measures, such as extending European Central Bank support for emerging market currencies—for example, through currency swap arrangements—and a more regional approach to debt management to avoid clustering in the sovereign debt market.

Customized support

Some countries may suffer further delays in returning to growth. Others, especially those that started out with sounder domestic policies, are more resilient, but remain at risk from the fallout of the global recession. The IMF is closely involved in the region, providing financial support and policy advice in cooperation with the European Union and other multilateral and regional partners. The IMF has tailored its support to meet the different needs in the region by:

- Extending financial support to those hit hardest by the crisis, helping them ease the extent of fiscal adjustment and repair banking systems. Countries that currently have IMF-supported programs in place include Belarus, Hungary (see box), Latvia, Romania, Serbia, and Ukraine.
- Providing insurance to "innocent bystanders" with sound economic fundamentals but still at risk of being affected by spillovers from the crisis (for example, Poland).
- Providing advice to countries that do not need financial support.

The crisis has left emerging Europe with a vexing list of problems. Some of these are domestic, but many others are part of the European agenda of unresolved issues. Constrained by fixed exchange rates, high foreign currency debt, or both, most countries must tread carefully, keeping their deficits under control and limiting their monetary policy response. As elsewhere in Europe, the financial sector to-do list is long and includes in many cases the need to recapitalize the banking system. Given the dominance of cross-border banks owned by parent banks based in advanced European countries, this problem clearly goes beyond emerging Europe to encompass Europe as a whole. Its solution requires an update of the Europewide framework for financial supervision and regulation.

Adjusting to a postcrisis world

In the longer run, the more fundamental question is about emerging Europe's business model. The crisis response, as crucial as it is in the short run, is creating "exit problems" in many areas—from central bank liquidity operations to government guarantees in the financial and real sectors.

But perhaps the most pressing postcrisis problem concerns the question of how emerging Europe, after so many years of abundant capital inflows, will adjust to the realities of the postcrisis world. These massive capital movements allowed the accumulation of large current account deficits and softened budget constraints for fiscal policy and the private sector alike, resulting in unsustainable credit growth in many cases. Of course, sooner or later, foreign capital will again be drawn to what will remain a relatively fast-growing region, but the flows are likely to be small compared with the past.

Adjusting to this new reality will not be easy. It will require the right mix of macroeconomic and structural policies to earn and keep the trust of international financial markets and safeguard the growth potential of Europe's emerging economies. Although often painful, governments will have to embrace and facilitate structural change, including through ***measures to improve the business environment and labor mobility, enabling countries to diversify away from producing nontradables to tradables***. For current and prospective EU members this ties in tightly with the European Union's mission to integrate European labor and goods and services markets and the much-needed rejuvenation of the Lisbon Agenda. Governments across emerging Europe also need to strengthen their fiscal accounts and invest in financial governance in concert with the rest of Europe.

Facing the crisis: Hungary

Hungary was one of the first emerging economies in Europe to turn to the IMF when the global financial turbulence worsened in late 2008. Over much of the past decade, large current account and fiscal deficits had led to high levels of external and government debt. The capital inflows that funded the current account deficits spurred rapid credit growth, much of which was denominated in foreign currencies. In October 2008, the government suddenly faced difficulties in issuing debt, banks struggled to obtain foreign currency funding, and the exchange rate depreciated sharply.

Hungary's economic program, which is being supported by the IMF, the European Union, and the World Bank, aims to strengthen government finances and maintain financial stability, so as to provide the foundation for a robust and sustained improvement in living standards. Thus far, thanks to the implementation of macroeconomic and financial policies in line with the program, government and external financing have stabilized, and a severe contraction of credit to the economy has been avoided. Looking ahead, the consistent implementation of sound policies provides the best opportunity for Hungary to weather its current difficulties.

Rethinking the euro area admission rules

One way to help this process is by ***resurrecting a European framework that seems to have fallen victim to the crisis: the euro area accession process***. The euro, like a fixed exchange rate, may not be for everyone. But clarifying the road map to the euro can help countries with sound policies navigate the postcrisis world. Needless to say, this will not be easy. What is needed is a joint effort and the close cooperation of the countries wanting to join, current euro area members, the European Union, and the European Central Bank.

More fundamentally, there are trade-offs between eastern European countries' aspirations and EU rules.

If it hadn't been for existing EU commitments and objectives, eastern European countries might have chosen different policies in response to the crisis. For example, some countries might have decided to regulate financial subsidiaries and bank branches more closely. Others, with fiscal room to maneuver, might have been able to enact more countercyclical fiscal stimulus, as most euro area countries have done.

Longer term, there may be a case not only for clarifying the road map for euro accession, but for revisiting the accession criteria themselves, which were conceived for a much more homogenous group of countries. For example, some argue that the price stability criterion should differentiate between inevitable structural inflation related to catch-up growth (which is welcome) and inflation associated with loose macroeconomic policies (which is not). Others have put a question mark next to the necessity of ERM II membership, in particular for countries with already firmly fixed exchange rates (countries wishing to adopt the euro must participate in the exchange rate mechanism for two years without severe tensions).

Of course, it is hard to tell what such differences in the policy-setting framework would entail for many of the small open economies in emerging Europe. The rules and commitments that come with EU membership were designed for good reasons, and revising them, even temporarily, will often come at a cost. Still, the discussion seems worth having, and worth having soon.

Toward a stronger Europe

Europe could emerge stronger if the right choices are made now. The integration of Europe's economies has been a tremendous success story. This success could now be at risk. The trick is to manage the crisis, preserve the progress that has been made, and revamp Europe's frameworks and reform agenda. Meeting this challenge will require much stronger coordination and "more Europe." If Europe's governments succeed, the region will emerge with stronger institutions and a more vibrant and robust economy—better able to face not only today's challenges but also those of the future. ■

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