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Hard truths about the eurozone crisis

There has been little honest reflection within the European Commission about the eurozone crisis. Until now?

'*I've seen things you people wouldn't believe [...] All those moments will be lost in time, like tears in rain.*'

It is not often one finds European officials quoting significant moments from pop culture, let alone an outgoing director-general for economic and financial affairs — the European Commission's most senior economics official — quoting Ridley Scott's *Blade Runner*. But that is how Marco Buti introduces a recent piece summing up his period in office between 2008 and 2019.

Buti's contribution is significant as personal reflection but also because it raises the more general question of how the EU and its institutions will commemorate the tenth anniversary of the eurozone crisis.

Crediting itself

When it came to revisiting the global financial crisis, Brussels did not hold back. In August 2017, to mark the tenth anniversary of its onset, the commission issued a statement blaming the spill-over to Europe on the United States and giving itself credit for prompt action to stave off the worst. The press release was however issued on 9 August — anniversary of the failure of the French bank Paribas' US property funds.

Subprime and Lehman could be safely blamed on the US. What, however, will the European institutions make of the ten-year anniversary of the eurozone crisis and its various phases between 2010 and 2015?

Last year, addressing the European Parliament on the 20th anniversary of the introduction of the euro, the then commission president, Jean-Claude Juncker, admitted there had been a lack of solidarity with Greece. He acknowledged there had been 'reckless austerity' (*l'austérité irréfléchie*). But he had the gall to suggest that the Commission had

succumbed to the influence of the International Monetary Fund, as though the agenda of austerity and 'structural reform' had been imposed from outside. We will have to wait for his memoirs for him to really spill the beans.

The traumatic history of the last ten years deserves better. That is what makes Buti's *vade mecum* worthy of attention. He speaks from the heart of the apparatus. He treads carefully, couching his remarks as lessons for the future. But his report is unsparing as to the handling of the crisis and revealing as to the lessons learned by key officials in Brussels.

Broader dynamics

For Buti a correct understanding begins by distinguishing between the problems of Greece, which he regards as *sui generis*, and the broader dynamics of the eurozone crisis. The confusion of the two itself contributed to the mishandling:

'The Greek fiscal woes led to looking at the other countries through a 'fiscal lens', which I believe to have been a mistake ... if Ireland had come to fall before Greece, perhaps different causes for the crisis would have been diagnosed for other programme countries, events could have unfolded quite differently, and we would probably be telling an altogether different story.'

If Ireland had been the model rather than Greece, the focus would have been on the aftershocks of the north Atlantic banking crisis of 2008 and imbalances in the private economy — not fiscal discipline and public-debt sustainability. For Buti, the lessons for Europe ought to begin not with Greece in 2010 but indeed with the deep crisis in the Baltic region over the winter of 2008-9.

The Baltics also demonstrated that, once the crisis began, even a small country could pose an acute contagion risk.

There, a vastly disproportionate inflow of foreign capital and a roaring property boom came to a crashing halt. Latvia faced a profound financial and economic crisis. Countries which appeared to be in solid fiscal shape were tumbled deep into deficit. As Buti remarks, it ought to have been clear from that point that treating the fiscal balance as a test of robust financial health was macroeconomically naïve. As would soon become evident in Ireland and Spain, a fiscal surplus could easily result from an unsustainable private-sector boom — and when that boom came to an end the balance would

plunge into the red.

The Baltics also demonstrated that, once the crisis began, even a small country could pose an acute contagion risk. In early 2009 there was a threat that the crisis might spread via the banking system to Denmark and Sweden or, via a shock devaluation of the pegged exchange rates of the Baltic states, to the rest of eastern Europe. To contain the crisis required a concerted approach across all three states and action by the banking sector as well as government. But again the eurozone paid little attention. It was not until the summer of 2012 that banking union moved centre stage. Eight years on, it is still incomplete.

Tête-a-tête

The Greek crisis having exploded and with uncertainty spreading across public debt markets, the moment Buti chooses to focus on is not the spring of 2010 (when the policy of extend-and-pretend towards Greece was initiated) or 2012 (with the Greek debt write-off and the 'whatever it takes' commitment by the head of the European Central Bank, Mario Draghi). It is the autumn of 2010 and the Deauville declaration by Nicholas Sarkozy and Angela Merkel.

On 18 October, after a *tête-a-tête* in the Normandy resort, the French president and the German chancellor stunned the rest of the eurozone by announcing that they had agreed that by 2013 a robust financial stability mechanism should be put in place, replacing the improvised European Financial Stability Facility and European Financial Stabilisation Mechanism. To satisfy the hardliners in Berlin this would be flanked in future bail-outs by 'haircuts' for bondholders. The then ECB president, Jean-Claude Trichet, and the rest of the Eurogroup of eurozone finance ministers were horrified.

For Buti this was Europe's Lehman moment, when misplaced emphasis on the need for creditors to be held to account produced a huge surge in systemic uncertainty. In tones which echo the hard-boiled rhetoric of US crisis-fighters such as Tim Geithner, Obama's Treasury secretary, Buti decries the uncertainty the Deauville declaration unleashed.

How to balance risk-reduction with risk-sharing remains the fundamental obstacle to further movement on

With remarkable frankness he concludes that 'EU-level decisions should be insulated as much as possible from domestic political economy considerations'. Why? Because politicians answerable to domestic publics, such as Merkel in 2010, are likely to take a moralistic line, demanding creditors be bailed in. But in a crisis

> 'processing everything through the "moral hazard lens" does not lead to sound policies. Whilst providing the right incentives for policy-making is essential, moral hazard considerations have to be tempered by the need for urgent policy responses. This is particularly true in times of economic and financial stress, as was the case in Greece, for instance, or in the sovereign debt crisis in the euro area in 2011-12.'

Buti's desire to limit the influence of politics does not imply on his part aversion to market fundamentalism. On the contrary, what makes a hard, political line so dangerous is the volatility of markets. In a crisis situation markets do not apply pressure to borrowers gradually. In a situation of uncertainty 'the financial markets change suddenly from benign phases to extremes, like Greece's treasury rate shooting up by more than 30 percentage points after having been closely aligned with those of the Bund for most of the last ten years of EMU'. To rely on the threat of bail-in and the normal operation of creditor discipline to act as a restraint on fiscal policy would be to engage in a 'daring undertaking'.

Ruinous bail-out

It is easy to sympathise with Buti's image of enlightened European bureaucrats balancing between the chaos of the markets and the conservative financial populism of the politicians. But what Buti never spells out is how the costs and benefits should be balanced. Taking bail-ins off the agenda and prioritising creditor confidence means absorbing the costs on the public balance sheet — in this case saddling Irish taxpayers with a ruinously expensive bail-out, not just of its own bank creditors but indirectly those of the rest of Europe too.

This might be justified if the risk were truly systemic. But as Ashoka Mody and Martin Sandbu have insisted, this is a judgement call. In their view it is far from evident that either the Irish banking system or the Deauville announcement were equivalent to the Lehman shock.

In fairness to Buti, he does not defend the Irish crisis package. He leaves no doubt that the eurozone can only function in the long run if the costs of ensuring stability are shared. This is not just a requirement of political legitimacy. It is also a functional imperative, since tough debt workouts on a national basis risk unleashing an uncontrollable downward spiral that will generate contagion and spill over to the entire system.

Eurozone reform

How to balance risk-reduction with risk-sharing remains the fundamental obstacle to further movement on eurozone reform. And in this respect Buti argues that Europe took a fatefully wrong turn when conservative fiscal hawks such as Germany backed the austerity agenda of the G20 meeting at Toronto in the summer of 2010.

Given the fragility of the recovery, the withdrawal of stimulus was premature. As Buti laconically remarks, 'In the aftermath of crises, early withdrawal of fiscal support can be very damaging …' Millions of unemployed paid the price.

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And the turn to austerity resulted in a dislocation of the policy-making mechanism. Whereas in the 1970s economists worried about fiscal looseness forcing the hands of central bankers in printing money, now central bankers were forced to expand credit to offset the refusal of politicians to act—'quantitative easing' became the counterpart to fiscal austerity, enabling it by offsetting its worst effects. As Buti comments, 'Today, we face the opposite dynamics: … excessive fiscal prudence is a form of fiscal dominance hampering the effort of the central bank to fulfil its mandate.'

The failure to take advantage of low interest rates to carry out a much-needed surge in public investment is a deep political puzzle. But in the eurozone it has an added constitutional dimension. If, as Buti insists, the complement to monetary union must be risk-sharing, the paralysis of fiscal policy has shifted the burden to the balance sheet of the central bank: 'The limits of this choice, however, are evident today as the ECB is overburdened in fulfilling its mandate.'

Sustained and cogent

Whatever one thinks about the detail of Buti's analysis, this is certainly the most sustained and cogent narrative of recent history and its implications to come out of the Brussels machine. For the health of Europe it is essential that this reckoning be deepened and the political conclusions drawn.

The combination of intergovernmentalism in European politics with stealth federalism by way of the ECB is unsustainable in the long run. It is

fragile as a mechanism for managing future crises. And it lacks legitimacy. Instead, Buti argues for the development of the EU's federal institutions, backed by political legitimacy by way of the European Parliament.

In keeping with the ominous note of his opening, Buti invokes the open letter which Keynes addressed to the US president, Franklin D Roosevelt, in 1933: 'I do not blame Mr Ickes [US secretary of the interior] for being cautious and careful. But the risks of less speed must be weighed against those of more haste. He must get across the crevasses before it is dark.'

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