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EXIT STRATEGIES: HOW SOON? HOW FAST? HOW TO COORDINATE?

A EUROPEAN PERSPECTIVE ON PHASING OUT THE EMERGENCY MEASURES TAKEN IN RESPONSE TO THE ECONOMIC CRISIS

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Exit Strategies: How Soon? How Fast? How to Coordinate?

A European perspective on phasing out the emergency measures taken in response to the economic crisis

Brussels Forum Paper Series

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1 Introduction[1]

The emergency measures, taken in response to the crisis, are not sustainable in the long run and must be phased out eventually. How soon, how fast, and in what order? This is one of the most important economic questions of the next few years.

At the end of 2008, there was widespread fear that the near-meltdown of the U.S. and European financial systems would result in a worldwide economic collapse of a magnitude and duration similar to the Great Depression of the 1930s. Thanks to the fast, resolute, and coordinated reactions of central banks and governments, collapse has been averted. Despite the tough times that still lie ahead, the world economy has been put on a path to recovery.

The crisis, however, necessitated a number of extraordinary interventions and actions by governments and central banks. The emergency measures, taken in response to the crisis, are not sustainable in the long run and must be phased out eventually. How soon, how fast, and in what order? This is one of the most important economic questions of the next few years. Getting the answer wrong could prove enormously costly. If the fiscal and monetary exit takes place too fast, we risk plunging back into recession or at least prolonging a feeble recovery, leading to an even larger loss in permanent output. The dangers of premature fiscal and monetary exit would be particularly acute in countries where the banking sector still has not been properly recapitalized and restructured. On the other hand, if the fiscal exit takes place too slowly, sovereign debt crises will become the next big crisis, of which Dubai and Greece may appear in retrospect to have been merely early warning signals. Finally, overly slow monetary retrenchment may encourage the renewed growth of asset bubbles.

On both sides of the Atlantic these dangers are fully recognized. However, some systematic differences in economic situation and outlook between the European Union and the United States are discernible and worth noting. In particular, there are two important differences in the economic situation of the transatlantic economies. First, the United States has been faster and more systematic at recapitalizing and restructuring its banks than the European Union, as indicated by International Monetary Fund (IMF) estimates of past and future write-downs (IMF 2009c). Second, the United States continues to enjoy the benefits afforded by the dollar as the global reserve currency, retaining an extraordinary capacity for sovereign borrowing at a time when sovereign borrowing constraints have already become a very real and serious issue in parts of Europe. The absence of a federal budget in Europe and the uneven situation of European national governments mean that problems affecting the weaker EU countries could lead to serious contagion effects.

Then there are the differences in outlook. Some of these—like the somewhat lower priority given to fiscal consolidation in the United States—can be explained at least in part by objective differences. In Europe, there is widespread pessimism regarding the permanent character of the output losses incurred during the crisis. The standard expectation is that only part of the output gap can be recovered, so that growth will eventually resume at the pre-crisis pace but from a lower output level. In the United States, by contrast, there is much more optimism regarding the long-term economic consequences of the crisis, and therefore about the consequences for public finances (Pisani-Ferry and Posen 2010). Other differences, in particular the greater willingness on the part of the Federal Reserve to sustain loose monetary policy compared with the European Central Bank (ECB), may be of a more philosophical nature, at least to some extent. However, these philosophical differences could lead to very real tensions if the perception of this gap eventually led to a substantial further depreciation

[1] This paper is based on and developed from the Oct. 2009 Bruegel Policy Brief "A European Exit Strategy," by Jürgen von Hagen, Jean Pisani-Ferry, and Jakob von Weizsäcker, and prepared for the informal ECOFIN meeting of the Swedish presidency held in Gothenburg.

of the U.S. dollar against the euro, which would make it even harder to achieve the substantial real effective depreciation that the weaker euro area countries need. This scenario of a very weak dollar would turn out to be particularly uncomfortable for the European Union if China were to continue its peg to the U.S. dollar and thus depreciate heavily against the euro as well.

This illustrates a much broader point. Exit strategies are not only about getting the timing right in each individual country. Ideally, they also require substantial international coordination. This is true across the Atlantic and even more among the heavily-integrated member states of the European Union. Exit strategies also require a careful sequencing and balancing of instruments, since it is by no means clear that fiscal, monetary, and banking sector policies should all follow the same exit trajectory.

This paper explores these three critical questions about exit strategies in the European context. It addresses: How fast can and should normalization take place? How should budgetary, monetary and financial-sector policies be sequenced? And how can and should these steps be coordinated—especially within the euro area, but also beyond?

The next section looks at the conditions we are currently confronting. The third section explores the interdependence of exit policy instruments and what this interdependence implies. The fourth section develops a sequenced exit strategy and discusses its implementation. The fifth section summarizes a set of policy recommendations for a European exit from the emergency responses put in place during the economic crisis. The exit path and sequence for the United States may take a different form than the one outlined below for Europe. But an exit strategy will ultimately be necessary there, too, as part of a return to more normal policies on both sides of the Atlantic and around the world.

Exit strategies are not only about getting the timing right in each individual country. Ideally, they also require substantial international coordination.

2 The Post-Crisis Landscape

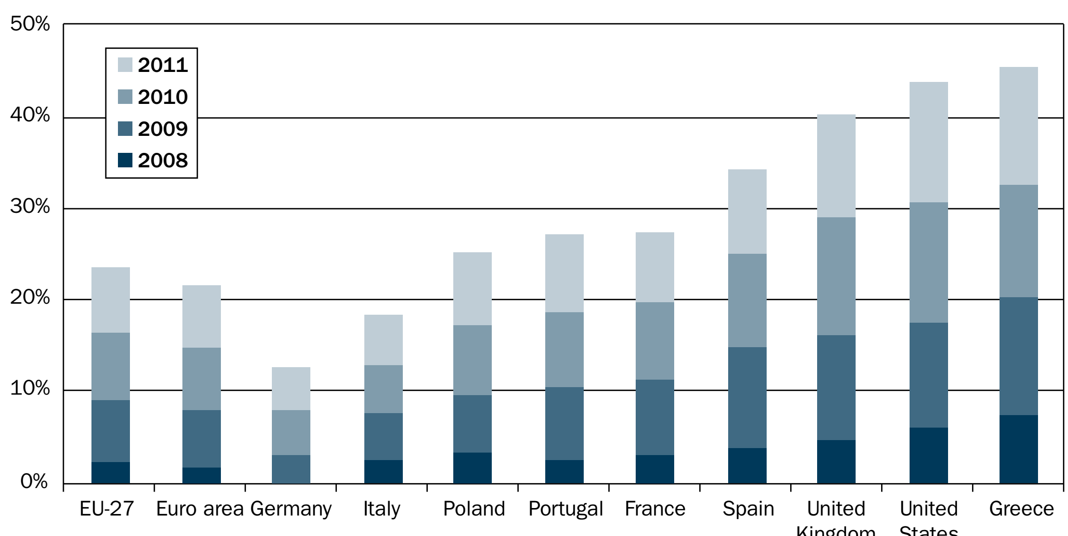
Eighteen months after the biggest global financial crisis in history and the worst recession in a generation, monetary, fiscal, and financial sector policy continue to operate in crisis mode on both sides of the Atlantic.

Eighteen months after the biggest global financial crisis in history and the worst recession in a generation, monetary, fiscal, and financial sector policy continue to operate in crisis mode on both sides of the Atlantic. In the European Union, which will be the main subject of analysis of this paper, the ECB has started winding down its exceptional liquidity provision facilities (which allowed for temporary, short-term liquidity assistance to endangered financial institutions), but it has kept interest rates at near-zero. On the fiscal side, stimulus packages introduced in 2009 have generally been maintained for 2010, and in most countries budget consolidation—the reordering of public finances—has not yet begun. The resulting surge in budget deficits (see Figure 1) in the European Union is unprecedented. As a consequence, the average debt-to-GDP ratio in the euro area is projected to increase by around 30 percentage points to reach 90 percent of gross domestic product (GDP) by 2014. The projected increase is significantly higher still for a number of individual EU member states.

It should be pointed out in this context that the countries whose fiscal deficits are largest are not necessarily those with the highest fiscal stimulus, for two reasons.

- First, since the discretionary stimulus is essentially defined as the discretionary *increase* in the budget deficit, a country like Germany was able to contribute to the European fiscal stimulus disproportionately while keeping its deficit well below the average. Italy did not contribute at all to the European stimulus because of its initially weak fiscal situation; and while the fiscal stimulus was larger in the U.S. than in the EU average, a mechanical comparison of annual deficits would substantially overestimate the size of that difference in discretionary stimulus (Saha und von Weizsäcker 2009).
- Second, by far the largest part of the budgetary deterioration is attributable to economic developments rather than to discretionary decisions. In Spain, for example, the budgetary

Figure 1: Surging deficits in response to the crisis
Cumulative budget deficits 2008-2011 as a percentage of GDP at market prices



Source: AMECO database, ECFIN

balance has moved from a surplus to a deficit in excess of 10 percent of GDP as a consequence of a collapse in tax receipts. This is akin to the familiar cyclical change in the budget deficit, but part of this deterioration is in fact 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 (see for example Cerra and Saxena 2008; Pisani-Ferry and van Pottelsberghe 2009; and IMF 2009b), implying a lasting shortfall in government revenues. As a result, there will be an increase in the structural budgetary deficit.

At the same time, 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 the financial sector easier access to central bank money has caused a rapid and significant expansion (and changes in the composition) of the balance sheets of central banks. So far, this policy of "quantitative" and "qualitative easing" (see Box 1) has merely compensated for the drop in the money created by commercial banks with every unit of bank money, due to the deleveraging of commercial banks. This phenomenon, which is technically called a drop in the money multiplier, has meant that the expansive monetary policy pursued by central banks has not affected broad monetary aggregates to date, and has not therefore 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.

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Box 1. Qualitative and quantitative easing by central banks

Qualitative easing is where a central bank purchases (low-quality) private assets and so directly influences their yield and sells a corresponding amount of government bonds to prevent the stock of base money from increasing. Such interventions can directly or indirectly support private banks by soaking up more or less toxic assets and giving them good-quality assets in return. The ECB in particular has engaged in qualitative easing of this kind as shown in Table 1.

Quantitative easing refers to outright purchases of a variety of assets, thus allowing the stock of base money to increase. It is 'unconventional' only in the sense that it departs from the usual practice of central banks of targeting short-term interest rates without regard to the supply of base money, and that central banks bought a wider range of assets in terms of borrower quality than before. This policy has caused very substantial increases in the supply of base money, especially in the case of the Bank of England, the U.S. Federal Reserve and the Swiss National Bank.

Table 1: Quantitative vs qualitative easing during the current crisis

	No expansion of base money (qualitative easing)	Expansion of base money (qualitative easing)
Purchase of private assets (credit easing)	ECB	BoE, Fed, SNB
Purchase of government bonds		BoE, Fed
Purchase of foreign currency assets (forex intervention)		SNB

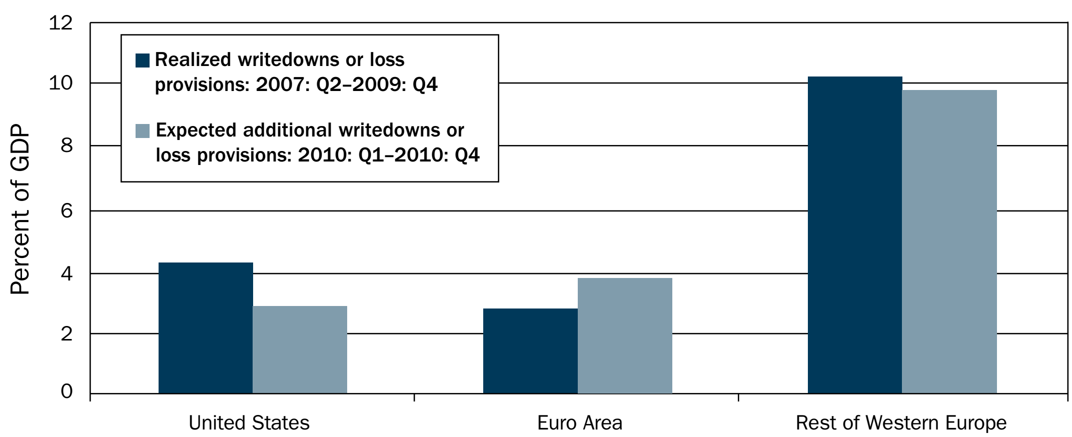
Source: Meier (2009), on the basis of announcements made by end-June 2009.

So far, European governments have focused on emergency measures to prevent the collapse of the financial system without fully addressing the fundamental issue of undercapitalization of the banks.

The banking systems have also been supported directly by governments through guarantee schemes and recapitalization. These measures have proven successful in restoring a degree of financial stability. However, the most recent estimates of the necessary write-downs in the banking sector (see Figure 2) raise the question of whether the recapitalization that has been achieved to date has been sufficient. It certainly would appear that the United States, despite having been at the center of the crisis, has already progressed further in sorting out the banking problems of Europe, at least on average (IMF 2009c).

So far, European governments have focused on emergency measures to prevent the collapse of the financial system without fully addressing the fundamental issue of undercapitalization of the banks. The state of the banking sector varies from country to country and in the absence of comprehensive and transparent "stress tests," there is little evidence as to the extent of differences across countries. Meanwhile banks are borrowing at near-zero interest rates and investing in higher-yielding assets, 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—with undesirable economic consequences. Given this risk, it would be unwise to undertake the necessary fiscal and monetary policy exit without first addressing the remaining problems of the financial sector.

Figure 2: Reported and estimated potential write-downs in the bank sector



Source: IMF (2009c), Bloomberg
Note: Rest of Western Europe includes Denmark, Iceland, Norway, Sweden, Switzerland, and the United Kingdom.

3 Policy Instruments and Strategic Interdependence

An appropriate exit strategy from the current extraordinary policy measures 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"[2] in the medium term;

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 three exit objectives involves budgetary consolidation, monetary tightening, and the withdrawal of guarantees and exceptional liquidity support for banks. Table 2 provides an overview of 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 a sound exit strategy. A stylized summary of the likely direct and indirect impact of exit policies on the exit and other major policy objectives is provided in Table 3.

It is instructive to explore these various effects in some 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 in the short term, especially where consolidation relies on increasing tax rates. Such a reduction in economic activity would tend to positively impact price stability but 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 program, so it is ambiguous.

The impact of monetary tightening turns out to be rather similar to the impact of budgetary consolidation, so to some extent they can be thought of as policy substitutes. But there are two important differences. While the impact of budgetary consolidation on price stability tends to be positive, the indirect impact of monetary

[2] The output gap is the difference between potential output and actual output.

Table 2: 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 recapitalization and restructuring	Withdrawal of liquidity support for banking sector Macroprudential oversight

Note: macroprudential oversight is categorized here as belonging to central banking because it is assumed that, following the decisions by the European Council in June, this task will largely be performed by central banks.

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.

Table 3: Direct and indirect impact of exit policies on exit and other major objectives (direct impact in blue)

		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 recapitalization and restructuring	-/+	+		+
	Macroprudential oversight	+	+		0

tightening on debt sustainability would tend 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. On the one hand, monetary tightening tends to reduce financial-sector profitability, thereby increasing the vulnerability of ailing banks. On the other hand, 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 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 renewed instability in the financial sector.

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: 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, listed as “other policies” in Table 3: bank recapitalization and restructuring as well as macroprudential oversight can serve as additional instruments to reach the main policy objectives.

4 Designing an Exit Strategy

The European Council concluded in June 2009 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." On this fiscal side, this was made more concrete when the Council of Ministers of Finance agreed in December 2009 on country specific deadlines to bring deficits back below 3 percent for those member states in excessive deficit procedure. And for Greece, the exceptional step of rather detailed prescriptions and monitoring by the European Union was announced in February 2010. However, the European exit strategy clearly needs to reach well beyond the Stability and Growth Pact (SGP).

A prerequisite: Complete the recapitalization and restructuring of ailing banks

In fact, we would argue that bank recapitalization and restructuring, not fiscal retrenchment, should be the first step in an exit strategy. This was indeed one of the major lessons of the failed attempts at engineering recovery in Japan in the late 1990s without having cured the woes of the banking system. Once accomplished in full, recapitalization and restructuring 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 a critical factor in all this, especially within the euro area: for countries where big banks are still in an insecure state 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 recapitalization is easier said than done. The principal difficulty is a political one: it is hard to make the case to electorates angry at the financial sector and reluctant to see more taxpayers' money used to recapitalize the remaining ailing banks. It should be argued forcefully that delaying recapitalization is likely to be even more costly, as the example of Japan in the 1990s illustrates. Also, it should be pointed out that recapitalization can even be a profitable public investment if handled correctly, as was the case in Sweden. Proper incentives for member states not to procrastinate should be provided and European coordination can help in this respect:

- First, credible deadlines should be set regarding the phasing out of government guarantees at the European level, using EU state-aid rules to enforce this deadline.
- 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 normalization (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 recapitalization. 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 reprivatization.

Swift bank recapitalization is easier said than done. The principal difficulty is a political one: it is hard to make the case to electorates angry at the financial sector and reluctant to see more taxpayers' money used to recapitalize the remaining ailing banks.

The debt-to-GDP ratio for the EU27 could still stand at around 100 percent of GDP in 2020, even if one assumes a full withdrawal of the stimulus packages in 2011 and a budgetary consolidation rate of 0.5 percent of GDP per annum thereafter.

- Last but not least, 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).[3]

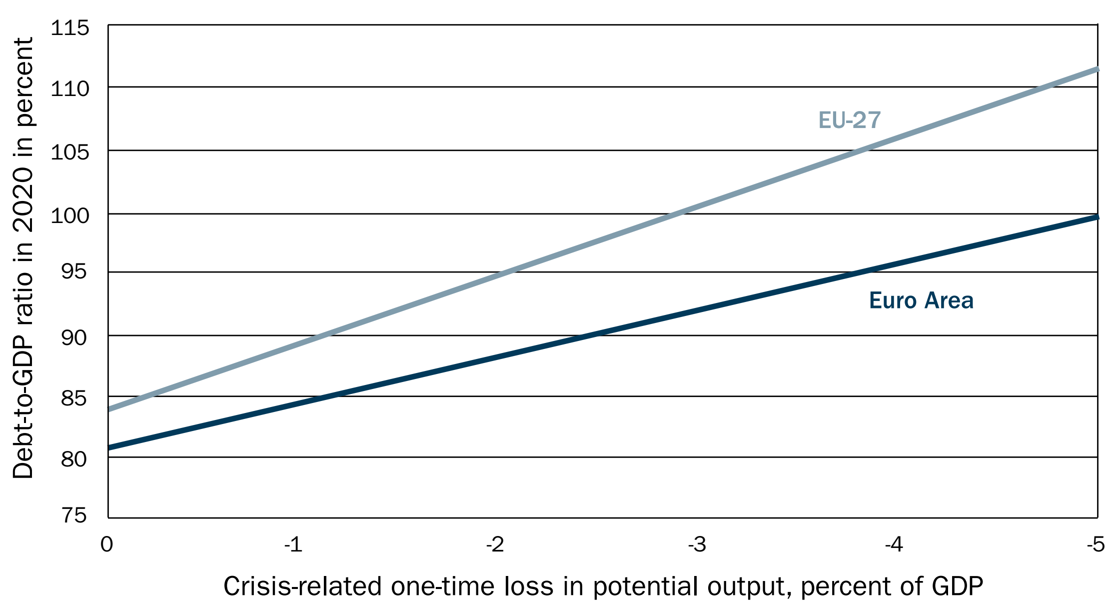
The first macro step: Budgetary consolidation

Budgetary consolidation should come before monetary tightening. The main reason is that fiscal policy is the more costly and less nimble stimulus instrument. In addition, 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 would reduce inflationary pressures, thereby allowing central banks to sustain an accommodating 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.

The extent to which the budgetary outlook has worsened during the crisis is illustrated in Figure 3. According to our simple fiscal simulation, the debt-to-GDP ratio for the EU27 could still stand at around 100 percent of GDP in 2020, even if one assumes 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 SGP. This debt level could be unacceptably high, not least because of the rapidly increasing

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

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



Source: Bruegel simulations, see Box 2

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 modeled 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.

budgetary cost of aging populations linked to unfunded pensions, long-term care, and health liabilities.

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 European Union. (The challenge of consolidation will be greater still for a number of individual EU countries inside and outside the euro area).

From these simulations we can conclude that the budgetary consolidation required will be substantial on average.[4] In order to make this politically delicate and painful process credible and successful, a strong collective commitment under the SGP is needed at the European level. 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 budget consolidation should take place, enforced through medium-term sustainability programs that should be adopted by national parliaments by summer 2010. Reforms that improve public-finance sustainability in the medium run, notably pension reforms, are to be taken into account in the setting of budgetary objectives. With these comprehensive programs, EU member states should commit to a set minimum speed of consolidation and to the stabilization of debt ratios by 2014 at the latest.

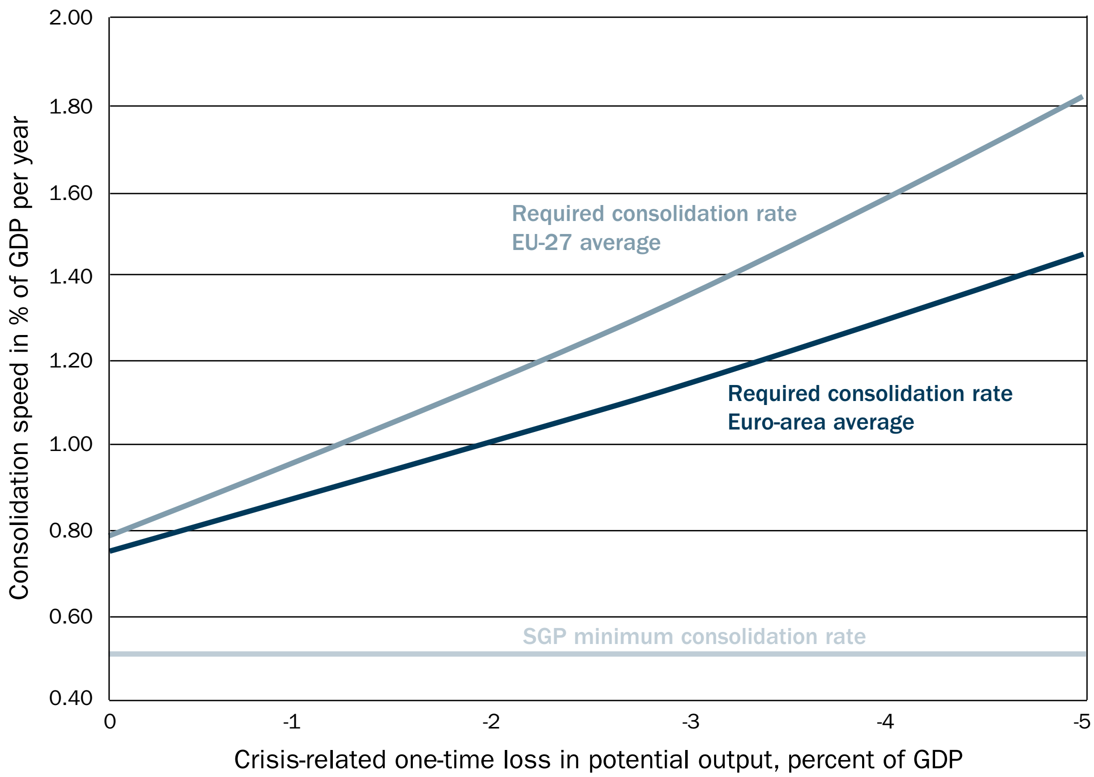
While medium-term sustainability programs are currently not part of the official discussion, the urgency of the challenge has by now been recognized by the European Commission. Within the ongoing deficit procedures, the deadlines for the reduction of deficits back to below 3 percent of GDP set in December 2009 imply annual consolidation rates of roughly 1 percent per year, which is twice the minimum consolidation rate under the SGP.

The primary focus should be on restoring the sustainability of public finances. The larger the debt ratio, the faster budget consolidation should take place, enforced through medium-term sustainability programs that should be adopted by national parliaments by summer 2010.

[4] This is also the conclusion of Cottarelli and Viñals (2009).

The Greek crisis may lead to a situation where vulnerable countries may have to consolidate very rapidly to restore credibility in the markets.

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



Source: Bruegel simulations, see Box 2

But 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 EU borders) is likely to represent an important drag on demand growth. The conditions that allowed some countries to experience painless consolidation in the past are unlikely to be met.[5] Therefore, the proposed national sustainability programs 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 notion of a maximum consolidation rate in the European aggregate might appear to be a recommendation of largely theoretical interest because EU member states have traditionally shown a tendency to consolidate at a slower pace than initially requested under the excessive deficit. However, the Greek crisis may have somewhat changed this. It could well lead to a situation where

[5] 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).

vulnerable countries may have to consolidate very rapidly to restore credibility in the markets, possibly implying that less vulnerable member states should ease their consolidation speed somewhat to avoid the risk of an overly sharp drop in demand.

The credibility of government commitments to sustainable public finances is the key to successful budget consolidation. We recommend that governments invest in strengthening domestic budgetary institutions, including via the establishment of 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 prioritized in the forthcoming update of the Lisbon Strategy—the EU's own mid-term economic strategy template.

Monetary policy: Arm's-length support

If budgetary policy is given precedence, the implication is that, consistent with central bank mandates, monetary policy should remain geared to price stability and would normalize once justified by expected price developments.[6] Against the backdrop 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 the central bankers' toolkit.

However, there is the danger, far from negligible, that a low interest-rate environment could once again fuel asset bubbles and recreate the conditions that contributed to the financial excesses of the early 2000s. Signs have already emerged that point in this direction. In response, a second policy instrument for central banks is needed in addition to the interest rate. Specifically, we recommend speeding up the establishment of the European Systemic Risk Board (ESRB), the creation of which was decided at the European Council in June 2009. Ideally, both the institution and the operational framework should be in place by summer 2010. This strengthened framework for macro-prudential supervision could be used *inter alia* to help time the phasing in of stricter and anti-cyclical capital buffers for banks so as to pre-empt the excessive leveraging that often goes hand in hand with bubbles.

Another—and 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 to engage formally in any form of *ex-ante* coordination that they might consider at odds with their independence and mandate. 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.

We recommend that governments invest in strengthening domestic budgetary institutions, including via the establishment of sustainability councils at the national level with the task of monitoring the development of public finances, advising overnments on strategies to reduce debt and giving public comments on, and assessments of, their countries' public finances.

[6] In this process of normalization, 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.

Coordination of economic policies is a controversial issue in the EU. The fact that coordination is needed at this particular juncture should therefore not be used as a pretext to attempt strengthening coordination permanently. Any attempt to do so would elicit suspicion and be likely to backfire.

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 internalize to some extent the often more hawkish exit preferences of the central banks to assure that the desired sequential exit can take place.

In general, governments and central banks should keep each other abreast of their intended policies so that they can 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

Coordination of economic policies is a controversial issue in the European Union. The fact that coordination is needed at this particular juncture—as explained above—should therefore not be used as a pretext to attempt strengthening coordination permanently. Any attempt to do so would elicit suspicion and be likely to backfire. It is, therefore, advisable to recognize explicitly the exceptional character of the situation and establish temporary arrangements for coordination that would be terminated within a pre-set timeframe. 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 (perhaps for two-and-a-half years, renewable once) reinforced consultation mechanism. The mechanism 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 framework for coordination in place, it will also be easier to develop "cooperative and coordinated exit strategies" at the global level, as called for at the G20 Summit in Pittsburgh in September 2009. G20 cooperation would need to include discussion of exchange rate developments, in particular with the United States and China.

5 Summary of Recommendations and Conclusion

On the basis of the above analysis, we propose the following recommendations:

1. In recognition of the exceptional nature of the current economic situation, EU governments and central banks should commit to coordinating exit strategies and set up a reinforced consultation mechanism to this effect.

2. Bank recapitalization and restructuring should be completed in all EU countries as a matter of urgency. Until the end of 2014, assessments of the budgetary situation in the member states and budgetary consolidation plans should be made on the basis of gross government debt *net of the value of bank capital held by the government*, instead of the usual 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 Program" covering the 2010-2015 period. In accordance with this program, each government should present to its parliament by summer 2010 a medium-term budgetary plan, including a debt target for end-2014 as well as annual minimum and maximum consolidation objectives.

4. The proposed European Sustainability Program should be enforced through the Stability and Growth Pact. This may require technical amendments to SGP procedures to accommodate the timetable for the exit in the aftermath of such a severe economic crisis. Governments should also be encouraged to strengthen their budgetary institutions, including via the establishment of independent Sustainability Councils.

5. Central banks, especially the ECB, should resist the temptation of premature monetary tightening through hikes in interest rates. Timely budgetary retrenchment and post-crisis adjustments in the private sector are set to weaken aggregate demand, thereby creating more room for monetary policy without increasing inflationary pressures. However, central banks should stand ready to increase interest rates to fend off potential inflationary threats as they emerge.

6. In order 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 be accelerated with a view to being operational by summer 2010.

The successful implementation of such a European exit strategy is clearly a daunting task by itself. Similarly, the implementation of a coherent exit strategy in the United States would also be an enormous achievement, beset by many challenges. The complexity of these challenges in both cases raises practical questions as to the extent to which transatlantic and even global coordination regarding exit strategies—while clearly desirable in theory—is actually realistic and therefore desirable in practice.[7] Ultimately, what is required is an ambitious yet pragmatic approach. The case for better coordination is already being made at the transatlantic and the G20 level and perhaps deserves to be made even more forcefully. At the same time, in the current crisis we clearly must not allow international coordination to turn into a largely ceremonial exercise—one which could then be abused both by friends of an unsustainable status quo and enemies of effective global economic governance.

The complexity of these challenges in both cases raises practical questions as to the extent to which transatlantic and even global coordination regarding exit strategies—while clearly desirable in theory—is actually realistic and therefore desirable in practice.

[7] See for example Joseph Stiglitz "Watchdogs need not bark together," *The Financial Times*, Feb. 10, 2009, where it is argued that insisting on the proper international coordination of financial regulation might be a "recipe for paralysis."

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