



Fair weather versus stormy weather governance: Implication for the international role of the euro

Jean Pisani-Ferry and André Sapir

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The issue

- Euro has become second international currency but role remains significantly below that of the US dollar
- Official doctrine guarded (neither.. nor)

What about the future? Three views

- Traditional view (Krugman, Matsuyama): considerable inertia because of network externalities, etc..
- Revisionist view (Chinn-Frankel, Flandreau): less inertia than you think, euro could displace the dollar fast
- Counterattack (Posen): euro suffers from weak geopolitical fundamentals

Here we look at one particular aspect: governance



Outline

- 1. The international role of the euro: selected evidence**
- 2. Why governance matters**
- 3. Can it change?**
- 4. Conclusions**



2. Why governance matters, especially for the euro

Euro is a “currency without a state”, or more precisely a “currency with several states”

Common monetary authority, but national political, fiscal, regulatory and supervisory authorities



When does governance matter?

Governance always matters, but it is not the only factor which makes a currency attractive or not

- Attractive to whom?
 - Different criteria for markets and for governments
- Attractive when?
 - In normal times, a currency's attractiveness depends less on governance and more on other factors such as the size of the economy and of its financial markets, and the currency's stability, although the latter partly depends on good governance.
 - In crisis times, speed and flexibility of the authorities, which depend upon the governance framework, are crucial.



What makes a currency attractive?

	Normal times	Crisis times
Markets	<p>Price stability. Expectations.</p> <p>Size and depth of financial markets</p> <p>Governance system</p> <ul style="list-style-type: none">- Transparency- Policy predictability- Regulatory stability	<p>Internal crisis management</p> <ul style="list-style-type: none">- Liquidity provision- Regulatory adjustments- Case-by-case restructuring <p>Deep fiscal pockets</p> <p>Political strength</p> <ul style="list-style-type: none">- Fragmentation/break-up risk
Governments	<p>Stability: prices, ER, IR</p> <p>Governance system</p>	<p>External crisis management (pegged currencies & others)</p> <ul style="list-style-type: none">- FX intervention- Macro-financial assistance- Debt restructuring



Normal times: EMU@10

- **Governance**

- Transparency and predictability of monetary policy
- Credibility of fiscal framework
- Macroeconomic policy interventions

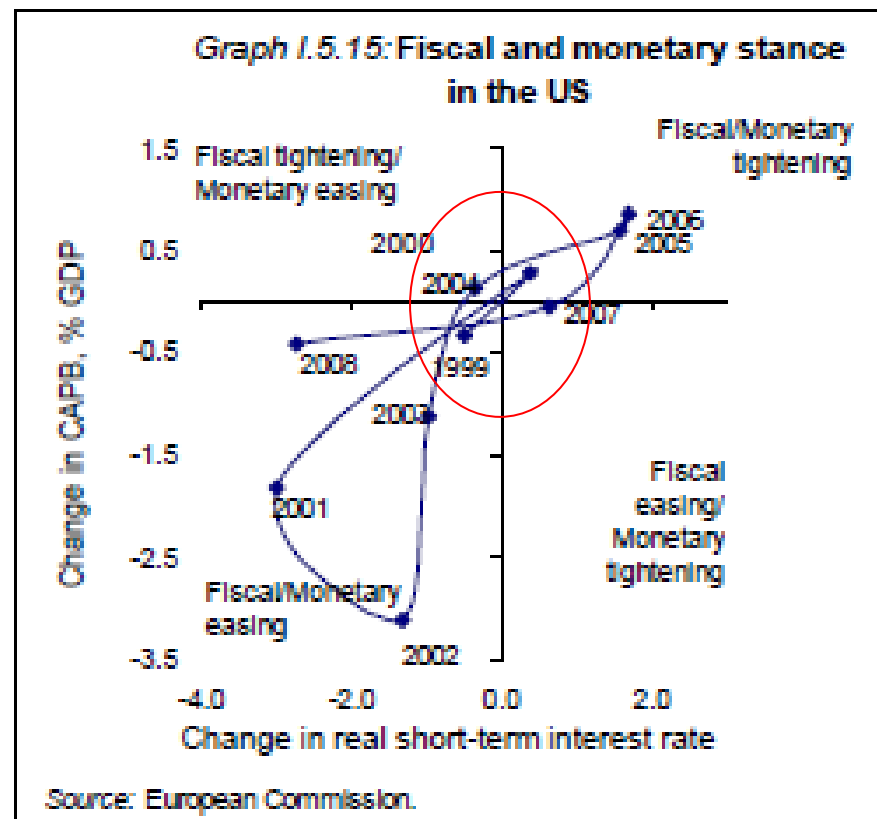
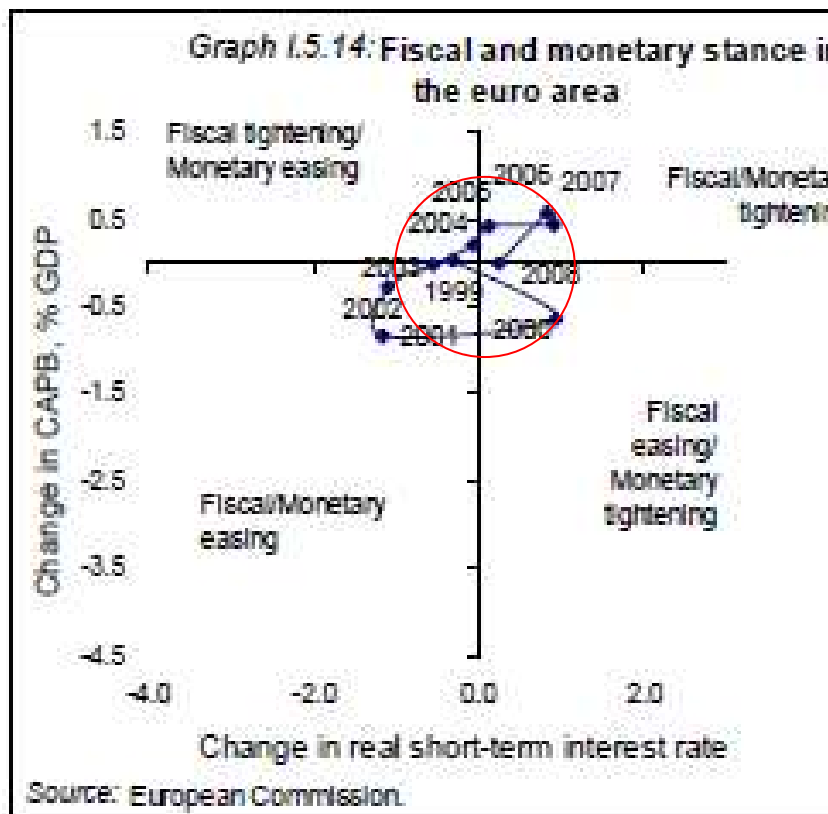
- **Performance**

- Inflation expectations
- Interest rate levels
- Interest rate surprises



Macroeconomic policy interventions

Policy swings are much bigger in the US than in the euro area



Unit circle

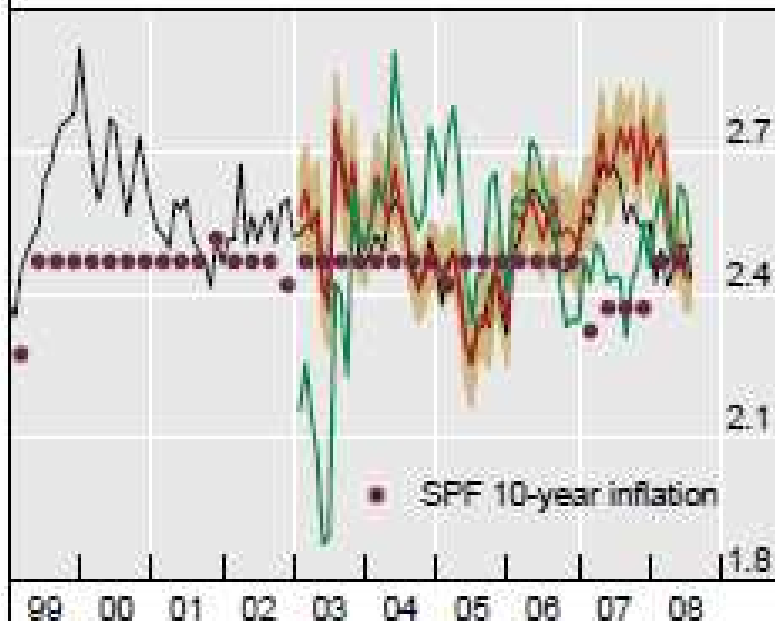


Inflation expectations

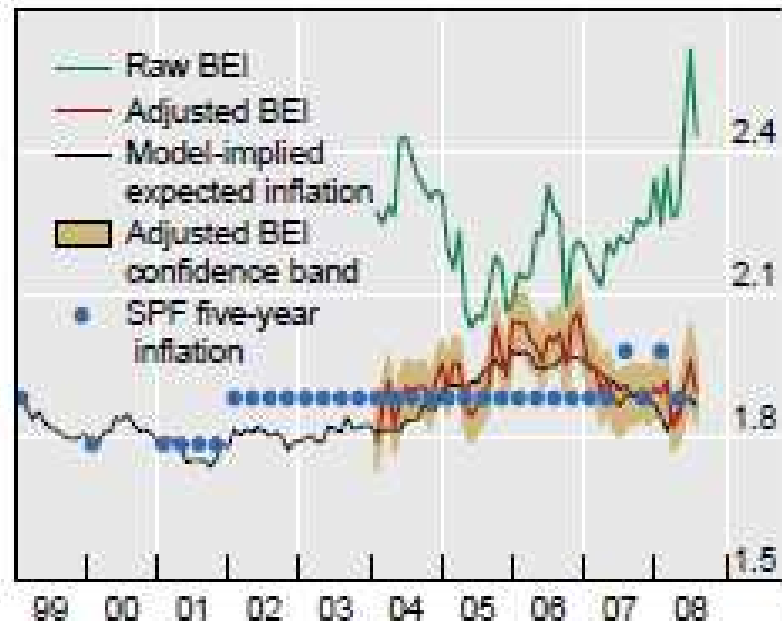
Ten-year break-even rates and inflation expectations

In per cent per year

United States



Euro area



Source: Peter Hördahl, BIS Quarterly Review, September 2008



The € policy framework has worked well, but...

- “A policy framework should not only be judged by its agility in fair-weather conditions, but also by its resilience in storm conditions.”
- “In bad times, the ability to convey relevant information to the ultimate decision-makers, to prevent conflicts of interest from obscuring choices, and to ensure swift decisions are key properties that depend on the system’s design.”
- “In this respect, it should be recalled that in a global perspective the last eight years have been benign.”
- “The policy framework of the euro has thus not yet been tested under stress.”
- “It remains to be seen how well EMU is set up to deal with events like disruptive global shocks or internal crises.”

JPF, PA, MB, JvH, LH and AS, Coming of Age: report on the euro area, Bruegel, 2008



Domestic financial crises – The storm gathers clouds

- **Liquidity provision: test was passed**
 - No discernible difference between ECB and Fed as regards timing and extent of liquidity provision
- **Limited coordination in prevention of banking crises**
 - No European supervisor and, so far, no commitment to create one. Rather, reliance on soft coordination and lead supervisor model
- **Ad-hoc cooperation between national governments in resolution of cross-border bank failures**
 - Fortis, Dexia September 2008
 - However questions on:
 - Adequacy of ad-hoc solutions
 - Longer-term evolution (break-up of Fortis following nationalisation of Dutch leg)



Domestic financial crises - Challenges

▪ Dilemma

- Need of an EU strategy to address potential negative spillovers
 - Recapitalization of cross-border banks
 - Toxic asset removal from cross-border banks
 - Deposit and interbank lending guarantee with perfect capital mobility
- But
 - No supranational EU fiscal authority
 - MS still regard large, cross-border banks as 'national champions'

▪ Hence

- EU strategy cannot be in the form of an EU fund to recapitalize, purchase assets or guarantee bank liabilities
- But considerable risks of regulatory arbitrage between MS (eg Ireland)



Domestic financial crises – State of play

▪ **EU finance ministers plan of October 7**

- MS free to: (1) recapitalize banks; (2) purchase their assets; and (3) provide guarantees of their liabilities, but with a minimum deposit insurance of €50,000
- MS to respect common principles: (1) timely and temporary support; (2) protect taxpayers and let shareholders pay; (3) governments free to change bank management & remuneration; (4) respect EU state aid; (5) no negative spillovers to other MS
- Same day: UK recapitalization (€32-64bn), ES TARP (€30-50bn)
- Next day: UK adds guarantee of new debt to refinance recap banks

▪ **Realistic, not ambitious. Lacks important ingredients:**

- Agent ('crisis committee') to ensure rapid recapitalization of cross-border banks. A surprising EU leader: Gordon Brown
- Fiscal solidarity rules if recapitalization too big for single MS
- Rules about fiscal consequences (SGP) and level playing field.



3. Can and will the euro governance change?

- **The next few weeks will be crucial for the credibility of EU / euro area agents**
 - Commission : only state aids and SGP?
 - Eurogroup/ECOFIN: more strategic role? Joint recapitalization action?
- **Just after the crisis: a supranational supervisor?**
 - Must include the UK, hence EU-wide rather than only euro area
 - Concerns mainly cross-border, systemic banks (roughly 50)
 - What about non-banks?



4. Conclusion for the international role of €

- **Currency without a state**
 - Works well during fair weather
 - Open question: what about crises (economic, financial, political)?

- **Difficult division of labour**
 - euro area (ECB, liquidity)
 - EU (regulation, competition)
 - What about fiscal rules?

- **Long-lasting lessons will be drawn from the crisis**