

Exit Strategies: An EU Perspective

Public support has been essential in supporting the economies stricken by the crisis. Addressing a successful exit strategy will be extremely challenging, as the economies are now interconnected, and the risk of policy spillover is significant. The European Union (EU) has taken the lead in defining and communicating a framework for unwinding public interventions in the financial sector. It combines a credible withdrawal of the support measures and good international coordination.

The need for a credible exit strategy

The design of a credible exit strategy and its clear signaling to the market is crucial before actual withdrawal of the support measures. This strategy is essential to anchor expectations and build the public confidence necessary for effective financial, fiscal, and monetary policy interventions. Even if the banking sector has been stabilized, it is not yet able to stand alone without government support. Therefore, to avoid distortion or inappropriate risk behavior, markets should receive a clear signal that public support will not be maintained beyond what is absolutely necessary. Exit strategies need to address several, possibly conflicting, objectives such as sustaining the recovery, rebuilding a stable and viable financial sector able to sustain lending without state support, and strengthening potential growth while tackling macroeconomic imbalances.

The EU exit strategy

The EU is leading the way in designing and developing public awareness of a credible fiscal and financial exit strategy and has a well established policy coordination framework based on both rules and peer pressure. EU countries will coordinate their various exit strategies through the existing regional budgetary framework, that is, the Stability and Growth Pact. Moreover, the EU Economic and Finance Ministers agreed on the main principles which should underlie the exit strategies: (1) reinforcing incentives to return to a competitive market, (2) ex ante exchange of information on the intention to phase out, (3) transparency toward the public and the financial sector, (4) set the timing on the basis of an assessment of the stability of the financial system (various macroeconomic and financing conditions), and (5) applying the initial phasing out to the general guarantee schemes.

The EU's coordination framework, though by no means perfect, has shed light on both the issues and the processes relevant for coordination. Even though the initial positions of the various countries were often different, and even though the recovery path and pace may vary across countries and regions, the case for coordination of exit strategies is robust and has been underlined by G-20 leaders.

Specificities of this crisis

Compared to the effort required in past crises, the design and implementation of strategies for unwinding public interventions in the present case has been and will remain particularly challenging, for three main reasons. First, the crisis has been truly global—the degree of interconnectedness and the risks of spillovers across countries are substantially higher than in previous crises as a result of increasing integration. Second, in several countries, today's rise

in deficits and debt comes on top of comparatively high starting points for the ratio of government debt to GDP; in many cases, the withdrawal of the fiscal stimulus and cyclical recovery will not be sufficient to prevent government debt ratios rising to even higher levels. Third, the problem of debt sustainability generated by the sizable fiscal deficits is compounded in many countries by the pension and health care effects of aging, which soon will start to hit hard.

As a consequence of these three issues, it is difficult to estimate whether the eventual impact of the crisis will be similar to those of previous crises. There is, for instance, a very high degree of uncertainty about the impact of this crisis on potential growth, about the valuation of assets and liabilities, and hence about the expected losses in the expanded public sector balance sheet.

Timing and coordination are essential

Given the interconnectedness, both in terms of geographic and policy areas, the timing of the phasing-out strategy will be crucial. It should be contingent on the situation in the economy, the financial markets, the health of the individual financial institutions, and possible national specificities. The identification of appropriate timing should also take into account the exit from other support measures, such as the fiscal stimulus and the conventional and unconventional support provided by the central banks.

In particular, several elements must be monitored: (1) macroeconomic conditions and stability (as reflected by indicators such as growth, insolvencies, unemployment, monetary conditions, external developments); (2) banks' behavior as it relates to a return to "normal market conditions," that is, adequately easy access to private financing; (3) the strength of the banks' balance sheets and their capacity to deal with impaired assets; and (4) the actual performance by the financial sector of its role in allocating capital in the economy and ensuring a proper functioning of the credit channels.