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Fiscal cliff lessons from the eurozone crisis

As the deadline to avert the fiscal cliff gets closer, US policy makers may want to learn some lessons from the way eurozone authorities managed their crisis. Let's consider four.

The first is that policy authorities tend to act too late, after financial markets have lost confidence. This is because of a belief among policy makers that the unpopularity of decisions will diminish only when voters understand that the alternative is much worse. Only on the verge of disaster do citizens understand that unpalatable policies are necessary. But by that point, financial markets start questioning the determination and ability of policy makers to face the situation and tend to lose confidence. At that point, even more unpalatable actions may be required.

The eurozone experience has shown how costly such a strategy can be. For instance, finding a consensus in Germany for providing financial support for Greece became possible only when the crisis reached a peak, in May 2010, and the euro seemed at risk. But at that point the size of the overall package required to stabilise the markets had risen substantially.

If the US authorities follow the same path and wait for market pressure to force a compromise, the decision might be more acceptable to both sides, being the last resort, but the burden on the economy might be dear. The sooner a solution is found, the less costly it is.

The second lesson to be learned from the European experience is that open political brinkmanship fuels financial instability. Games of chicken are won by the party which convinces the other that it will not compromise, even if it makes everybody worse off. Negotiations should ideally take place confidentially, and the result would be known only when it is reached. This is obviously difficult to achieve in democratic systems.

In the eurozone, brinkmanship has been frequently used to convince the other party in the negotiation. In particular, eurozone authorities had at times to threaten openly that they would let Greece fall out of the euro, in order to make the Greek policy-makers understand that there was no room for compromising on conditionality. This might have been effective in convincing the Greek government to stick to their commitments, but it also scared the markets away from Greece, and the eurozone.

If the opposing parts in the US start negotiating in public, from their apparently uncompromising positions, the risk of catastrophe will increasingly be discounted by the markets, with negative effects on confidence.

The third lesson is that partial solutions may temporarily solve problems but ultimately a piecemeal approach requires more comprehensive action later on, generally much earlier than expected. The political cost of such a strategy has been quite high.

European summits have had less and less impact on market sentiment, as the prospected solutions appeared to be partial and lacking a comprehensive plan. For instance, markets reversed the initial positive reaction to the agreement on the ESM last June, when they understood that the agreement on the banking union and fiscal union was still vague.

In the US, much emphasis has been put recently on the need to avoid the fiscal cliff, but less so on how to achieve the result in a sustainable way. Confidence is likely to vanish if policy makers do not come up with a credible medium term plan, based on realistic assumptions about growth and interest rates.

The fourth lesson which can be drawn from the eurozone crisis is that fiscal and structural problems can ultimately be settled only by the respective policies. Monetary policy can only help buying time for the relevant political sphere to design and implement concrete solutions. Experience shows, however, that if the time is too long the authorities in charge tend to relax, thinking that favorable market conditions are there to last, and ignoring that these conditions are partly the result of a deliberately accommodative monetary policy.

Each time the ECB succeeded in calming the markets with extraordinary measures, either the Securities Market Program or the Long Term Refinancing Operations, the pressure eased on the eurozone political authorities to pursue the adjustment and complete the institutional framework underlying the euro.This is the reason why the ECB's Open Market Transactions had to be made conditional on the political authorities' signed commitment to do their part of the job. Acting without such conditionality would entail the risk of losing credibility and compromising the effectiveness of monetary policy.

If a central bank gives the impression that it stands ready to be the "only game in town", it will end up being played. The other policy makers will have no incentive to take on their own responsibilities. This will ultimately drag the central bank into monetising the debt and lose its reputation.

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