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Thinking ahead for Europe

August 2011: What to do when the euro crisis reaches the core?

Daniel Gros and Thomas Mayer

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Investors are anticipating the unravelling of the 21 July 2011 'solution'. We argue that the EFSF cannot work as intended but if it were registered as a bank – which would give it access to unlimited ECB re-financing in case of emergency – the generalised breakdown of confidence could be stopped while leaving the management of public debt under the supervision of the finance ministers. The ECB could still manage liquidity as the 'EFSF-bank' would be subject to the same rules as all other banks and because the ECB would accept only good quality collateral from it. Moreover, the ECB could then stop its purchases of peripheral government bonds immediately.

Canaries used to be kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, miners knew that it was time to prepare for an emergency.

Greece, as it turns out, was the Eurozone's canary. It was nevertheless resuscitated, and a small rescue mechanism was set up to revive a further canary or two – but beyond this the warning was ignored. The miners kept on working. They convinced themselves that this was the canary's problem.

A Greek warning

The problems of Greece should have been recognised as the first manifestation of a general problem, namely that the global crisis was spreading to public debt as capital markets refused to refinance excessive levels of public debt, especially in the Eurozone, whose members can no longer rely on central bank support.

This has become particularly evident since the July 2011 European Council – the meeting that was supposed to end the crisis by settling the Greek case with a mixture of generous long-term financing at low interest rates and some private sector rescheduling and restructuring.

The Greek public might not appreciate it, but it has received preferential treatment from the EU. With the decisions taken at the July European Council, Greece will essentially have all its financing needs for the next decade arranged and is assured of paying less than 4% on the

Daniel Gros is Director of the Centre for European Policy Studies. This commentary was previously published by VoxEU, 11 August 2011.

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new debt it is incurring.[1] The two other countries with a programme, Ireland and Portugal, will have similarly low interest rates and loans with a longer maturity than now, but they are still expected to face the test of the markets in a few years' time.

The debt fears reach the core

But while Greece, Ireland, and Portugal obtained lower rates for their official long-term financing, Spain and Italy experienced a surge in their borrowing costs. Before the intervention of the ECB they were paying more than 6% for ten-year money.

It is clear that these countries cannot be expected to provide billions of euros in credits to Greece (and Portugal and Ireland) at approximately 3.5% when they are themselves paying so much more. Even France has come under market pressure as doubts have arisen over the country's ability to deal with both its actual and contingent liabilities. Europe's leaders wanted to be generous to Greece, but the supply of cheap funds is limited. Not everybody can be served this way.

The EFSF was designed for a peripheral crisis

In particular, the Eurozone rescue fund, the European Financial Stability Fund (EFSF) simply does not, and will not, have enough funds to undertake the massive bond purchases required to stabilise markets. It was sized to provide emergency financial support only to small peripheral countries such as Greece, Ireland, and Portugal.

Moreover, the structure of the EFSF makes it vulnerable to a domino effect.

- The rules of the EFSF imply that a country that encounters financial difficulties and asks for support from the EFSF can 'step out', i.e. no longer provide guarantees for any further debt issuance by the EFSF (See Art. 2(7) of the EFSF Framework Agreement).[2]
- Even if it is not explicitly regulated, it can be expected that a country facing high borrowing costs (as in the case of Italy and Spain if rates stay at crisis level) will step out as guarantor and only the core Eurozone members would remain to back the EFSF.

At this point, the debt burden on the core countries would become unbearable.

Dangers of applying the periphery solution to the core

This implies that a larger EFSF is not the solution; if anything it could accelerate the fall of the dominoes. The position of the French government – that the EFSF should be increased – does not make sense even from a narrow French point of view because financial markets have understood this risk and are driving up borrowing costs for France – the core country most in danger of losing its AAA rating. But if France loses its triple-A status and then has to 'step out' of the EFSF, only Germany (and some of its smaller neighbours) would be left to carry the whole burden. This would not only be politically unacceptable but also economically impossible – the Italian government debt alone is equivalent to the entire GDP of Germany.

How this drives the markets

In early August 2011, the domino effect started to kick in because financial markets do not wait for country after country to be downgraded; they tend to anticipate the endgame, or at least one potential scenario, namely the unravelling of the entire EFSF/ESM structure. Markets were caught between three, seemingly inconsistent constraints: 1) little chance of a

[1] See (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf)
[2] See (http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf)

sizeable increase in the borrowing capacity of the EFSF; 2) little chance of the introduction of Eurobonds; and 3) a great reluctance on the part of the ECB to engage in large-scale purchases of financially troubled governments' bonds.

The bank-government-debt snare

As usual, banks are the weakest link. They create negative feedback loops and accelerate the transmission of the domino effect. There are two reasons for this:

- Many banks hold large amounts of government debt;
- Their credit rating usually falls along with that of their own sovereign.

This implies that anyone expecting a country's downgrade would not only be selling government securities but also its bank shares. This, in turn, increases the cost of capital for the banks, making them even weaker. Moreover, even stronger banks – which see their own share prices falling and credit-default spreads widening – react by refusing to provide the other banks with interbank liquidity. The breakdown in the interbank market, in turn, leads to a breakdown of the credit circuit, which kills growth.

This was the dynamic that led to the severe recession experienced after the Lehman bankruptcy.

It is now apparent that capital markets are anticipating the potential for a doomsday scenario, with the economy falling abruptly into recession as the interbank market breaks down and public debt problems are expected to grow. Unfortunately, these expectations will materialise unless the breakdown of the interbank market is addressed immediately.

What needs to be done?

To avoid the worst scenario, the Eurozone needs a massive infusion of liquidity. Given that the existing cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size. Rather, the EFSF could simply be registered as a (special) bank in Luxembourg with access to re-financing by the ECB in a case of emergency. The EFSF, which we would prefer to call the European Monetary Fund (EMF) would then have access to ECB funding as do other banks, for which the central bank acts as a lender of last resort.

Adjustment funding and help for debt restructuring would be carried out by the EMF with the financial endowment already decided. Smaller secondary market intervention in case of limited liquidity gaps could be funded in the same way. However, in case of a big liquidity crunch, the EMF could access ECB facilities by borrowing against the government bonds it is purchasing as collateral. Assuming that the ECB insists on the top quality of the assets it takes for collateral—as for instance assured by a high rating—it would ensure that it only lends in case of a liquidity crunch and not when a country suffers insolvency.[3] The decision to intervene to buy national government bonds would be taken by the EMF, based on expert assessments and under the supervision by Finance Ministers and not, as de facto at present, by the ECB, whose task is not to determine fiscal policy in specific countries, but to look after price and financial stability for the euro area as a whole.

Moreover, the EMF would also be the proper place to formulate and monitor the conditionality that would have to go hand in hand with any EMF intervention, including buying bonds on the secondary markets. At present this is done implicitly by the ECB, which

[3] Cases of insolvency would have to be handled by the EMF without ECB help by giving adjustment help and, as a measure of last resort, facilitating debt restructuring. The limited market borrowing capacity of the EMF would ensure that debt is restructured when adjustment has failed.

uses its SMP to pressure the Italian government into reforms and fiscal adjustment. However, there is no representation of the European tax payers on the Governing Council of the ECB, which might have a tendency to be overly concerned about instability in financial markets and have too little regard for the interests of taxpayers.

The ECB would still be able to control liquidity developments for the entire euro area because once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing by the EMF would simply crowd out financing to other banks and thus not increase area-wide liquidity.

Backstopping the EFSF via the ECB—i.e. creating an EMF – would have the advantage over the current mess in that it leaves the management of public debt problems in the hands of the finance ministries, and provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence. In a crisis of confidence the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed.

The ECB is the only institution that can provide the required 'lending of last resort' quickly and in convincing quantities. It would of course be much better if the ECB did not have to 'bail out' the European rescue mechanism, but in this case one has to choose between two evils. Even a massive increase in the ECB's balance sheet (which, if the US experience is any guide, will not lead to inflation) constitutes a lesser evil than a breakdown of the Eurozone financial system.

What are the alternatives?

The dangers of introducing political union without democratic legitimacy.

Another solution touted by some has been to establish joint and several liability for euro area countries' debt by introducing Eurobonds. The danger here is that holding tax-payers fully and unconditionally liable for spending decisions taken in other countries would most likely turn into a poison pill for EMU. Political resistance against EMU would rise in the stronger countries, eventually leading to a probable break-up of EMU. Moreover, if the issuance of Eurobonds were limited to a part of national debt (say only 40-60 % of GDP as proposed), highly indebted countries would immediately be forced into a debt restructuring as they could no longer find buyers for the part only guaranteed nationally.[4] Moreover, this approach would require a change in the EU treaties and would probably not be compatible with the German constitution.

Another variant of Eurobonds would be for all euro area countries to provide a 'joint and several' guarantee for the EFSF. This would have still have most of the political disadvantages mentioned above, but at least it would not create the additional problems of the blue/red bond proposal.

Whatever the variant: Eurobonds can only make sense in a political union and even then only when debt levels are low.[5] When starting debt levels are so high that the markets suspect a debt overhang Eurobonds would amount to a large transfer of risk and of course strong expectations that future accumulations of debt will be treated in the same way.

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[4] It could be different if in case of default part of the bonds—say that consistent with a 60% debt ratio—were guaranteed by the community of euro area states (through a respective privision in the bond covenant). In this case, the guarantee would only kick in in case of default while market participants would have a better idea of the recovery value.

[5] The Federal government of the newly created US assumed the debt of the founding states because that debt had been incurred fighting for a common cause. This is certainly not the case in Europe today.

No silver bullet

Bringing EMU back to safe ground will of course only succeed if debt and deficits are reduced substantially. The financial crisis has clearly demonstrated that excessive debt loads and new deficits cannot be financed in anything but extremely benign markets. Countries that accumulate excessive debt will inevitably experience their 'Minsky moment', when the rolling of this debt becomes impossible. For a stable EMU a long-term programme of debt reduction is a *conditio sine qua non*. However, debt reduction takes time, hence the need for an effective crisis management mechanism along the lines sketched out above. One without the other will not work, and EMU will fail.

Our proposal will certainly dissatify the purists who regard EMU as the re-birth of the gold standard. For the purists, our proposal amounts to monetary financing of government debt behind a thin veil. We would respond by saying that in the real world of today a pure gold-standard-like arrangement will not work. In today's environment, the central bank needs to look after financial stability, which means that it needs to assume the role of a lender of last resort to banks and—because of the bank-government-debt nexus described above—also governments. The question is not whether, but how this role is performed.