How to fix crisis management in the Eurozone

Stefano Micossi
5 September 2011

This column takes stock of what we have learned from the Eurozone crisis and the policy responses. It discusses how Europe can put in place policies to reduce the chances of such a crisis repeating itself. By strengthening the Eurozone's ability to withstand speculative attacks, it argues that policymakers would make them much less likely.

After "market hurricane" season hit financial markets this summer, it's time to take stock of Eurozone crisis management. Two things stand out:

- On all fronts Eurozone governments are moving in the right direction, albeit too often falling "behind the curve" in the timing, size, and scope of their measures (Wyplosz 2011);
- There is a broad consensus of expert opinion on what still needs to be done to stabilise financial markets durably and put the Eurozone crisis to rest once and for all.

Removing the underlying causes of financial instability

The sovereign debt crisis of the Eurozone has had very real economic root causes.
With their March 2011 conclusions, the European Council decided on a radical overhaul of economic governance and new economic policy orientations for the Eurozone that are in principle capable not only of enforcing budgetary discipline but also gradually removing the underlying economic rigidities and divergent wages and costs.
While it is true that the Council's record in enforcing its polices with member states is not good, discipline from financial markets can be expected to play a strong role in keeping countries on track.
Moreover, in their recent letter to van Rompuy, Merkel and Sarkozy advocate useful measures to strengthen national budgetary rules, including German-type constitutional debt brakes (which France, Italy, and Spain have already decided to adopt), and a recommendation to link closely all structural funds to needed reforms with explicit policy conditionality. A supranational fiscal authority would not be necessary – although some transparency mechanism at EU level as advocated by Burda and Gerlach (2010) would help.
The new legal procedure to prevent excessive imbalances and the European Systemic Risk Board should prevent the buildup of excessive private indebtedness. To this end, the Board, or the ECB, must be able and ready to impose higher reserve or capital requirements selectively when credit accelerates undesirably in some member states. The present arrangements that leave this responsibility to national authorities seem weak.
Debt sustainability also requires higher growth, which will not come simply as a result of better public finances and cost convergence – indeed, these measures are likely to initially depress economic activity and worsen debt sustainability (Wyplosz 2011). Thus, when they meet in October, the European Council should focus attention on growth strategies (see Amato et al. 2010), including market opening measures in services and strong EU-financed investment in energy, transport, and communication networks for the internal market, which deserve fast-track procedures.

Stabilising expectations

Fixing the economic root-causes of the Eurozone debt crisis will not suffice if financial markets fear that sovereign debts will not be honoured. The problem is how to break a vicious circle of self-fulfilling expectations of a sequence of ever bigger bailouts – essentially fed by fear that at some stage Germany will no longer be willing to bear the burden of residual guarantor of Eurozone sovereign debt obligations (De Grauwe 2011a). In order to do so, the Eurozone must be collectively much more willing to use the euro to stabilise sovereign debt markets and to issue Union bonds as required, through the common Stability Fund, to ensure that distressed sovereign debt can be rolled over while financial stabilisation measure are implemented (De Grauwe 2011b, Eichengreen 2010, Gros and Mayer 2011, Micossi 2011b, Wyplosz 2011).

The role of the ECB ...

In this regard, the ECB already has under Article 18.1 its statute all the powers needed to act as a lender of last resort to stabilise the banking system and the sovereign debt markets, but it has been rather reluctant to use them to purchase distressed sovereigns – also due to staunch opposition by some members of its governing board. But when a market meltdown seemed once again possible, e.g. in November 2010 and in recent weeks, ECB interventions were very effective in stopping them. These interventions were routinely sterilised so that they did not entailed any unwanted loosening of monetary policy; nor did they entail any direct extension of credit to distressed debtors, since they were purchased in the secondary market.
However, the ECB does not want to remain stuck with large amounts of distressed debt that one day might have to be restructured, thus impairing its capital and its independence; but the problem would be easily resolved if the EFSF, later to become the European Stability Mechanism, were allowed to take up these holdings and provide in exchange Union bonds to the ECB (fully backed by the joint and several guaranty of the member states). These holdings of distressed debt would be taken up by the EFSF in the context of their financial assistance programme to their issuers, and could be returned to them under buy-back arrangements. Thus, the EFSF would not take any additional risk on these holdings other than that already implicit in the financial assistance loans. An alternative possibility is to turn the EFSF (and the ESM) into a bank and let it undertake directly open market operations, drawing on an unlimited credit line from the ECB,

as suggested by Gros and Mayer (2011); however, it is probably preferable to have the ECB manage all open market intervention.

It remains a separate question whether or not the ECB should abandon its one-sided obsession with price stability and expand liquidity more aggressively – even, if need be, with quantitative easing (Valiante 2011).

... and the EFSF

As for the EFSF, important decisions have already been adopted by the Eurozone Council on March 11 to raise its resources (to an affective amount of €440 billion, later €500 billion when the Stability Fund will be made permanent, and on 21 July to extend the EFSF operational powers to various secondary market and financing operations. After the usual initial confusion and public bickering, the member states are now committed to give legal force to these decisions by the end of this month – which has already played a role in calming financial markets`.

There are two problems that still require Council's attention.

- First, even after the recent increases, the resources available to the EFSF are insufficient to create a convincing deterrent against market attacks on a large Eurozone member (Gros and Giovannini 2011). One possible approach to raise its ammunitions would be to transform the present credit commitment by the member states into (callable) permanent capital of the EFSF, and change its statute to let it borrow from capital markets up to three times its capital. A trillion and a half of firing power should be enough to convince financial markets that the Eurozone will not break apart. With its own capital, the EFSF would also be able, under most foreseeable circumstances, to carry directly all the risks connected with its lending, and the guarantee on its loans by its member states would only represent an *ultima ratio* unlikely to be ever called upon. The direct linkage between individual EFSF financing operations and national budgets would be effectively rescinded. The rating of the member states' sovereign paper would in all likelihood be unaffected. De facto, the European Monetary Fund, as first advocated by Daniel Gros and me in 2008, would be born (see Gros and Micossi 2008).
- The second problem concerns the governance of the EFSF (De la Dehesa 2011, Micossi 2011a). Under current arrangements, the decision to grant financial assistance to a member state in difficulty requires the unanimity of the Governors, *ie* the ministers of finance of the member states of the Eurozone. It would of course be up to the Governors to decide the lending policy of the EFSF; but its implementation should be left to the executive board, as in the IMF. This is very important not only to move the decisions on financial assistance out of the whims of national politics, but also to ensure the rapidity of action required to meet an emergency.

What about Eurobonds?

Eurobonds is a good idea that has morphed into a diversion. Most proponents intend it as a scheme to substitute in large-scale national sovereign debts with jointly issued (and guaranteed) Union (or Eurozone?) bonds (Gros 2011, Micossi 2011a). The rationale behind it is that in this manner national sovereign debts would all take up the same quality – presumably closer to that of the best-rated national bonds – and all fears of sovereign default would vanish.

Quite clearly, no such scheme will be ever acceptable to the German and Northern European public opinion without full political union and complete centralisation of budgetary policies (De Grauwe 2011a). Gros (2011) has called attention to the dramatic differences not only in budgetary conditions but also the quality of public sector governance arrangements as insurmountable obstacles to rapid progress in this direction. Therefore, much of the discussion of liquidity benefits or borrowing costs in innumerable schemes seems to me idle talk, since all such schemes are a political non-starter. They are indeed counterproductive, since they mobilise the public opinion in Eurozone creditor countries against all rescue operations.

However, some of the benefits of issuing jointly bonds assisted by a joint guarantee can be reaped without transferring sovereign liabilities from one member state to another. This would be precisely the case with the scheme previously discussed of a EFSF endowed with its own capital and capable of issuing jointly guaranteed bonds to a large scale to undertake financial assistance, bank recapitalisation, and debt exchanges of a varying nature (at market price) to preserve the Eurozone's stability. These bonds would be issued to support adjustment programmes capable of restoring full debt sustainability of distressed sovereign debtors and related operations, thus strengthening the credibility of the euro. Their first line of defence would be the EFSF (ESM) capital, while the ultimate member states' guarantee would not in all likelihood ever be called upon. By strengthening the Eurozone's ability to withstand speculative attacks, they would make them much less likely.

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