2.1 BUILDING A CRISIS MANAGEMENT FRAMEWORK

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Abstract

The euro area has faced an unprecedented crisis. While there are several lessons to be learnt from this crisis, in this contribution we focus on just one: how to improve crisis management in the EU in general, and the euro area in particular. We ascribe three aspects to successful crisis management: 1) crisis prevention 2) crisis mitigation and 3) crisis resolution.

The EU has already taken some steps to improve crisis management in the euro area; many others have been suggested by other commentators. In this policy brief, we develop a comprehensive framework for crisis management, briefly evaluate the steps taken and the suggestion already on the table and suggest some new but politically feasible ways forward.

Contents

1. Background

While the discussion of the euro area crisis has focused primarily on issues in the sovereign debt market, it is instructive to remember at the outset that this crisis is not primarily a sovereign crisis but one that originated in the private financial sector. As often happens in credit crises, private sector debt is taken on to public balance sheets which makes them fragile and can, as in this case, result in serious dislocations of the sovereign debt market.

Though Greece's problems have at least partly had to do with misreporting statistics and a genuinely unsustainable public balance sheet, the problems faced by countries such as Ireland and Spain originated primarily in excessive risk taking and unsustainable levels of activity in the private financial markets. In fact, Ireland and Spain were the star pupils of the Stability and Growth Pact, hitherto the euro area's main bulwark against fiscal problems while bigger states such as Germany and France violated the pact at least as often as they respected its provisions. In the decade prior to the crisis, Ireland halved its debt stock to 23% of GDP and Spain reduced its debt burden from 60% to 40%.

That is why any discussion on the management of the euro area's fiscal problems cannot be had in isolation from a discussion of crisis management in the financial sector. In fact, as this paper highlights, there are several lessons that can be usefully applied to the management of sovereign debt crisis from measures that have been suggested and used in the management of crises in the financial sector. What makes these lessons particularly useful is that discussions on the management of banking crises are more advanced than the discussions on managing sovereign debt problems.

Thus far, the policy discussions on handling problems with sovereign debt

1) have ignored the role of problems in the financial sector;

2) have assumed unrealistic levels of government control of economic outcomes;

3) have focussed primarily on crisis mitigation rather than crisis resolution

4) have ignored the limits and idiosyncrasies of policy making in modern democracies;

5) have ignored the difficulties in bringing about structural changes and have forgotten that

6) in order to try and achieve multiple policy objectives, governments need to have a larger portfolio of policy instruments.

2. Introduction

In order to influence policy making on economic governance in the EU, it is important to highlight the assumptions and parameters that are implicit in our approach to improving the crisis management framework in the euro area. At minimum, any such framework must successfully address 1) the problems faced by Greece on the one hand, 2) and Spain & Ireland on the other. It must also address 3) the underlying all-critical question of how best to manage continuing divergences within the euro area in a way that is not destabilizing. Our aim in this contribution is to devise a complete crisis management framework that would tackle these three distinct aspects of the ongoing crisis.

In suggesting this framework, we make the following **assumptions** from which the conclusions and policy proposals put forward in this paper naturally follow:

- No new institution should be established unless really needed – the EU institutional landscape is already too fragmented
- Political appetite from Member States (MS) for 'an ever closer fiscal union' is likely to remain particularly low in the near future
- Changes to the Treaty, at least in the short term, are not really possible

- Given a choice we have a preference for a pre-planned crisis management system that minimises the role of ad hoc midnight emergency cabinets
- Fiscal transfers to other MS are against the spirit, if not the letter of the Treaty and should avoided as far as possible especially since they can trigger a political backlash
- While prevention is better than cure, it is never foolproof so we need to always be prepared for contingencies.

Next, we list some **observations** which form the basis for our analysis:

- In today's increasingly complex and interconnected world, there are serious limits to the degree of influence that government policies can have on economic decision making
- Such limits are especially binding in an open free market economy where the room that governments have for manoeuvre is seriously limited
- Room for national level policy action in the euro area is especially constricted because of loss of monetary policy autonomy, the confines (at least on paper) of the Stability and Growth Pact, highly interconnected financial markets and an increasingly harmonized regulatory environment
- Economic outcomes are partly deterministic and partly stochastic so even with the best of intentions there are limits to what governments can do and control in their economies

Our objectives, assumptions and observations lead us to conclude that the European Economic Governance **discussions need to focus on four things** in particular.

1. Better economic policy co-ordination to the extent this is possible under the terms of the current treaty and prevailing political climate. Co-ordination, it is to be remembered, is not the same as uniformity
2. A recognition that even with the best of intentions and good co-ordination, euro area economies are structurally, culturally and politically different enough so that substantial economic divergences are likely to continue into the near future. Since these cannot be wished away, policy makers need to focus on devising instruments and approaches that can help mitigate potential negative impacts, such as large imbalances, that might result from these divergences
3. A recognition that even with better co-ordination and new policy instruments in place, the threat of future crises would remain ever present so any sensible policy making would need to put in place an effective crisis management system for the euro area
4. Effective crisis management frameworks must be put in place for both sovereigns as well as the financial (banking) sector. Sovereigns provide the final backstop for the banking sector and the banking sector in turn is a significant provider of finance to sovereigns. The high degree of interdependence between the financial sector and sovereigns has become clear in this crisis. Banking crises often lead to sovereign debt problems and sovereign debt problems will almost inevitably increase the likelihood of a banking collapse

Now that we have stated our assumptions and methodology upfront, the rest of this paper will address the design of an effective crisis management framework for sovereigns in the euro area. The underlying assumption here is that a parallel crisis management framework for the financial sector is already being put in place (The Financial Crisis, Causes & Cures, Re-Define Book, 2010).

3. Designing an effective crisis management framework

Crisis management is firstly and foremost about minimising the likelihood of occurrence by putting in place effective ex ante risk reducing policies – **Crisis prevention**. No matter how good such policies look on paper, economic externalities, and endogenous developments in financial markets or stochastic factors can dislocate even the best plans and trigger potentially destabilizing disturbances in the financial markets. These often take the form of liquidity black holes and/or asset prices collapses and/or a collapse in confidence. The challenge at this stage is to contain the crisis, limit damage, stop widespread contagion and restore confidence – **Crisis mitigation**. Even with the best of efforts to contain a crisis, sometimes it will deepen and spread. Under such a scenario, mitigation gives way to rescue and making a fresh start – **Crisis resolution**.

In fire-fighting terms, prevention comes from having a strong fire code, responsible behaviour and taking appropriate precautions. The distinction between crisis mitigation and resolution is somewhat arbitrary but nonetheless critical. Crisis mitigation is about putting out an incipient fire and stopping it from spreading. It will involve the use of smoke alarms, hand-held fire extinguishers, fire blankets and fire doors. Mitigating a crisis or a fire successfully often entails little cost or damage and going back to the 'normal state of affairs' is usually easy.

If the crisis or fire is too large or the mitigation tools are inadequate, the problems deepen and spread and cause widespread damage. This is where the big boys, the fire brigade or in the case of financial markets, recapitalizations or bankruptcy are needed to help limit damage and make a fresh start. The degree of collateral damage and the possibility of a healthy fresh start depend on the quality of crisis resolution and rescue measures, or in the case of fire, on the quality and response time of fire brigades and the existence of appropriate insurance policies.

Crisis prevention depends on 1) responsible fiscal and monetary policies, 2) sound regulation, 3) a countercyclical approach to policy making, 4) moderate to low levels of public and private debt, 5) minimising imbalances and 6) having sufficient room for policy manoeuvre to lean against unfavourable developments. Better co-ordination and surveillance can help too, particularly in the context of the euro area. Prudence and policy space are critical here.

Crisis mitigation has a lot to do with 1) moving quickly to restore confidence in the financial markets, 2) provision of temporary liquidity and balance of payment support and 3) ring fencing problems so as to minimise contagion. Speed of intervention, minimising conditionality and a credible scale of intervention are critical at this stage. Having a much clearer view of the endgame, in case mitigation fails, can also help calm nerves and restore some semblance of order in the market.

Crisis resolution often entails substantial costs and involves structural changes, particularly for private sector entities. 1) ex-ante contingency plans, 2) formalized speedy resolution frameworks and 3) the possibility of orderly restructuring are all essential elements of an effective crisis resolution toolkit. A fair burden sharing procedure, predictability and the possibility of redemption are critical at this stage.

Thus, an effective crisis management framework for the EU will focus on putting crisis prevention, crisis mitigation and crisis resolution tools in place for both the financial sector and sovereigns. In the next section, we discuss some of the main features that such a framework will entail, list what new policy measures have been put on the table and make suggestions on how to improve and strengthen the nascent crisis management apparatus that will need to be a central part of any reform of EU economic governance.

4. Crisis Prevention

A crisis prevention framework will focus on stopping the build up of excessive risks in the financial system as well as on limiting fiscal and macroeconomic imbalances. This is best achieved through a combination of: 1) prudent principles and targets 2) better euro area level co-ordination 3) that are owned by MS and 4) the availability and use of appropriate policy tools 5) in a countercyclical manner so as to minimise the build-up of risks. Importantly, such an approach would necessarily include private and public financial activity and have a macro and micro dimension.

We have at our disposal a set of five major policy categories that, at least in theory, can be used to manage economies in a way that best helps prevent the occurrence of a crisis. These are: 1) monetary policy 2) fiscal policy 3) regulatory policy 4) policies on competitiveness and 5) structural policies, listed in a rough order of short term flexibility.

However, not all of these policies are available to euro area governments. Even when policy space was available, it was not always used appropriately. In particular, euro area governments face some critical challenges which are that:

- Monetary policy is conducted by the ECB and national governments have no room for adjusting this to better fit local economic conditions
- The Stability and Growth Pact (SGP) has limited room for manoeuvre of fiscal policy (if not very effectively)
- Regulatory policy for the financial sector was lax and allowed far too much risks to build up in euro area financial systems
- Competitiveness has been ignored because the current account imbalances that allowed divergences in competitiveness to be sustained were ignored both by the SGP and by the financial regulators, and
- The political economy of structural policies is such that it is very hard to change them.

This meant that the divergent growth and inflation rates in the euro area led to sustained negative real interest rates in countries such as Ireland, Spain and Greece which brought about asset bubbles, especially in Spain and Greece. These bubbles were financed, in part, by financial institutions in low inflation slow growth economies such as France and Germany. When the financial crisis hit, both sets of countries were vulnerable and as public balance sheets absorbed financial system risk, markets reassessed the credit worthiness of countries within the euro area.

The fiscal balances that the SGP observed missed the build-up of these risks altogether and by the time Spain saw its fiscal account turn from being in surplus to having a 10% deficit, it was too late for crisis prevention measures to have any effect and the EU was forced to turn to crisis mitigation. This has been one of the drivers of efforts at the EU level to improve the crisis prevention framework in the euro area. Several policy measures have been suggested, some by EU institutions, others by academics and think tanks. We discuss these briefly and make our own suggestions for improvements.

EU Measures

The main measures already agreed (at least in principle) under this category are:

Measures to reduce financial sector risk

- The institution of a macro prudential approach to financial regulation that will monitor the build up of systemic risk
- Improving the quality and quantity of liquidity and capital buffers that 'leaves some powder dry' within financial institutions and reduces the likelihood of financial sector disturbances
- The introduction of countercyclical capital buffers that will help lean against excessive risk build up
- Other risk reducing regulatory measures such as derivative reform, compensation reform, regulating hedge funds

Measures to reduce fiscal risk

- Improving the quality, scope and timeliness of economic information in order to facilitate better co-ordination at the EU level and the introduction of the European Semester
- Strengthening the sanctions under the SGP and focusing not just on the values of the deficit and debt stock parameters but also their rate of change and the scope for early intervention before limits are breached
- Strengthening the EU macroeconomic framework which is currently very weak
- A renewed call to focus on policies for structural reform and measures to restore competitiveness in euro area countries that are lagging behind

Other suggestions include:

1) Introducing National Fiscal Councils
2) Taxing debt levels in excess of 60% (directly or indirectly)
3) Stronger sanctions in terms of withdrawing access to the ECB and to the EFSF in case of excessive debt levels
4) SGP implementation through an independent body at the EC level
5) The issuance of Eurobonds in various forms.

Policy discussion

The biggest indictment of the SGP in its current form was that Spain and Ireland, which did not violate the SGP and ran surpluses, were amongst the countries most vulnerable to the sovereign debt crisis. The SGP, with its exclusive focus on fiscal balances, completely ignored private sector imbalances and the related current account imbalances. So extending the mandate of the SGP to monitor risk building and excessive private sector, financial sector and current account imbalances is the sensible thing to do.

However, while fiscal policy might, at least for the most part, be under government control, other economic outcomes are the collective results of millions of individual decisions by economic actors so governments can at best have only a limited influence on them. The EU and its constituent states are not command-economies, so there are serious limits to what even willing governments are able to accomplish in the name of co-ordination or reduction of imbalances.

So, while the European semester, peer review of budgets and enhanced efforts at co-ordination are welcome steps there should be an explicit recognition at the outset that these steps will not eliminate imbalances and divergences but can only mitigate them somewhat.

Since most of the domestically originating observed financial instability in the EU can be traced back to intra-euro area divergences, there is an urgent need to also devise additional policy instruments that give governments more policy space to 1) try and mitigate divergences and 2) make sure that any divergences are managed to minimise imbalances and the externalities and financial instabilities associated with them.

Negative real interest rates were the major drivers of housing bubbles in countries such as Spain and Ireland and one of the causes of over-indebtedness in Greece. In the absence of any monetary policy space to manage significant real interest rate divergences, **the main options available to euro area countries are:**

- Using fiscal policy as the main adjustment tool. However, in order to compensate for the negative real interest rates observed in a country such as Spain, the government would have needed to run a fiscal surplus of the order of 8%-10% of GDP which, any political economist would agree, is next to impossible.

- Using structural policies and wage adjustments as the main policy tool. The problem here is that governments have only limited control on wage policies and that structural reforms of this kind are extremely difficult. Wage restraint in a time of fast economic growth is almost unheard of. While ideally there should be more structural reforms of the kind the EU has been calling for over decades, we should not delude ourselves with the likelihood and extent of any such reforms that might happen.

In other large economic federations such as the United States, fiscal transfers and labour mobility are far higher and offer stronger adjustment mechanisms to mitigate any problems caused by divergences but neither of these is an option for the euro area in the medium term.

The problems with other suggested proposals such as National Fiscal Councils, the European Monetary Fund, the Blue Bond proposal etc are that they all focus on the symptoms (fiscal accounts) rather than the fundamental causes, such as: limits to government fiat, stochastic economic shocks and the lack of sufficient policy space to run a countercyclical policy. The implicit assumption in many of these proposals is that it was a lack of willingness on the parts of euro area governments, rather than a lack of ability or policy options, that led us into this crisis. This assumption is seriously flawed.

Our Recommendations

In order to further strengthen the crisis prevention framework in the euro area, we propose:

- **Introducing differentiated reserve requirements run by national central banks:** Because the spread of real interest rates is a continuing source of divergences and imbalances, allowing national central banks to require domestic banking operations to hold different amounts of unremunerated (zero interest) reserves against liabilities can help adjust real interest rates so they are more suitable for the national economic conditions. This will help reduce the build up of excessive risks and imbalances. Currently the ECB levies uniform reserve requirements that it pays interest on. This will need to change. If this is legally complicated, a similar end-result can be achieved by using asset based reserves.

- **Using a countercyclical prudential and regulatory policy :** Member States have at their disposal a number of instruments such as asset based reserve requirements, loan to value ratios, financial transaction taxes, loan loss reverse targets and bank levies that can be used counter cyclically in conjunction with or as a substitute for the liability based reserves we have suggested above.

- **Using GDP Linked Bonds**: Member states could start issuing GDP linked bonds where the interest is linked to the GDP growth rate so debt service payments increase in boom times when a country can most afford them and fall in a slowdown giving the country some breathing space and thus acting to stop a temporary economic dip from turning into a recession. These bonds hardwire an automatic counter-cyclical fiscal policy which is stabilizing for the economy. Market surveys indicate that there is a growing appetite for such bonds.

- **Stress testing budgets and contingency budget plans:** Member states should be obliged to stress test their budgets against a number of scenarios that are decided by the European Commission, publish the results and take them into account to introduce more counter cyclicality in fiscal policy. In addition to this, MS should be made to publish contingency plans for fiscal policy that detail what a MS would do in the event of facing fiscal problems that would need to include 1) where it would obtain temporary liquidity from – how much and at what rate 2) which taxes it would raise 3) which expenditures would it cut 4) how it would deal with a solvency problem.

- **Lengthen the maturity profile of country debt:** The Commission should introduce minimum targets on the average maturity profile of a country's debt since, as we saw in the present crisis, MS such as the UK that had a longer maturity profile on their debt found it easier to tide over temporary dislocations in sovereign debt markets compared to MS with shorter maturity profiles who faced the prospect of rolling over large fractions of their debt under stressed market conditions.

5. Crisis Mitigation

Crisis mitigation is all about nipping incipient problems in the financial sector and the sovereign debt markets in the bud. Crisis mitigation comes into play at the first hint of financial market dislocation.

Since market expectations feed back into prices, which affect fundamentals as well as the future evolution of fundamentals, these expectations can become self-fulfilling. Contagion can come about as low confidence feeds back into expectations and afflicts other parts of the market portfolio. So a circuit breaker mechanism that can halt this feedback cycle should be at the core of crisis mitigation.

Crisis mitigation comprises four main sets of policies: 1) provision of liquidity 2) measures to restore confidence 3) limiting contagion and 4) having a predictable next stage in case mitigation does not work.

In fact, the main focus of new policies and measures in the euro area has been on crisis mitigation, where a number of new measures have already been introduced.

EU Measures

BOX: EU Crisis Mitigation Facilities

Facility Name	Legal Entity	Institution	Form of Support	Amount	Scope	Terms
ESFM	Private Entity	EC	Loan or Guarantee	EUR 60 billion	All MS	Non Concessional
EFSF	MoU	Eurofin	Loan or Guarantee	EUR 440 billion	Euro MS	Non Concessional
EBoP	EC	EC	Loan or Guarantee	EUR 60 billion	Non Euro MS	Non Concessional
Macro	EC	EC			Non MS	
ECB Bond Purchase	ECB	ECB	Market Support	EUR 60 billion?	Euro MS	No Explicit Concessionality
Greek Rescue	IMF/ EU MS Bilatreal	IMF		EUR 110 billion	Greece	Mixed

For the private financial sector, the crisis mitigation measures that have been introduced are: 1) temporary expansion of deposit guarantee schemes 2) provision of extensive government guarantees for bond issues by banks 3) confidence enhancing stress tests and 4) ECB measures (see Box below).

Additional measures that are being discussed and have been proposed include: 1) introducing minimum liquidity buffers 2) expanding capital buffers 3) issuance of contingent capital.

For sovereigns, measures put in place include 1) the rescue package for Greece 2) the EFSM 3) the EFSF 4) ECB measures (see Box below).

BOX: Crisis Mitigation Measures introduced by the ECB

For the financial sector

- Extra 12,6 and 1 month lending operations for commercial banks in addition to its normal 1 week and 3 month operations.
- Full allocation in some liquidity operations wherein banks were given access to unlimited funds at a given rate.
- Offering banks dollar funding which was mobilized through a dollar swap with the US Fed.
- Reducing the quality of collateral against which it lent from debt rated at least A to BBB-.
- Narrowing the interest rate corridor for its overnight deposit and lending facilities.
- Intervention in the market for covered bonds by instituting a EUR 60 billion facility. These bonds were backed by Mortgages or Public Sector loans.

For sovereigns

- Exempting Greek debt from minimum credit rating requirements for the purpose of collateral.
- Purchasing Greek, Irish and Spanish debt in the secondary market in order to help reduce some of the excessive margins the markets were charging these countries on their debt rollover.

Source: ECB Website and Financial Times

Policy discussion

The ECBs contribution to crisis mitigation measures has been large and substantial, especially for the banking sector. Many of the new facilities listed above were not envisioned at the time the ECB was designed and have not been formally a part of its policy armoury. So a first useful policy move would be to hardwire many of these 'new' facilities into the policy apparatus of the ECB so these could predictably be used as crisis mitigation tools in a future crisis.

There has been a renewed and growing interest in the idea of introducing Eurobonds. Much of the debate is somewhat misinformed and there is a perception that Eurobonds are 'new'. However Eurobonds of one kind or another have been in existence for several years now. The EIB borrowing in financial markets is a Eurobond as is borrowing by the EC for its Balance of Payment facility. If the EFSF ever issues any bonds, these too will be Eurobonds. There are several important aspects which need to be discussed for a true and accurate picture of what Eurobonds can and cannot do and whether they are indeed the panacea that several proponents sometimes make them out to be. For this it is important to remember that there are several different parameters that go into the design of such a bond so two Eurobonds with different design parameters would look very different from each other. The main parameters are: 1) Issuing entity 2) Purpose of issue 3) whether they are issued in lieu of or in addition to national bonds 4) guarantee mechanism.

Eurobonds can prove to be useful both for crisis prevention and crisis resolution and may also have a role in crisis mitigation but it is critical to remember that they are not a panacea. A more detailed appraisal of Eurobonds is contained in this compilation of papers so we do not expand on this discussion.

BOX: SWOT ANALYSIS OF THE EFSF (AND EFSM)

Strengths

- Substantial as long as the problem is limited to the periphery
- Involving all other members so increasing peace time incentives to monitor each other and limit moral hazard
- No upfront funding needed

Weaknesses

- Intended to only be primarily liquidity management tool
- Tackling a liquidity problem with a liquidity management tool solves it but tackling a solvency problem with this would make it worse and transfer the burden of adjustment from the private sector and international governments to euro area governments which would be politically poisonous
- The one month time period for action from request to issue can be too long in the midst of a crisis.
- The two stage process of the EFSF/EFSM issuing bonds and then giving the MS government a loan is needlessly complicated and expensive
- Temporary
- Too small to have any real impact especially if any of the larger MS gets into trouble. They can just about mitigate rollover risk for say a month, but then again, it might be much more sensible to issue guarantees instead of bonds
- The cost of funds provided (around 5%) is too high. A 5% interest burden would be very difficult for a country such as Greece to bear given its fragile fiscal situation
- The MS have decided against going for a preferred creditor status which exposes them to much higher levels of credit risk
- Because of the current structure (where the MS getting EFSF support no longer stands behind it) the size of the fund would diminish exactly when the demand for it would grow

Opportunities

- Could be the precursor of an EU wide or at least euro area wide fiscal instrument
- Can be made permanent to provide crisis mitigating liquidity support
- Could force the discussions on a more integrated EU crisis management framework
- Might grow with the size of the EU budget (the EUR 60 billion EFSM supported by the Commission budget), a longer-term objective of ever closer union.
- The EFSM should be the first port of call in the event of a crisis, and could effectively guarantee a much larger sum, e.g. EUR 300 billion or so (see below)

Threats

- At the high interest rates at which funds are being offered, this could exacerbate the solvency problem and be self defeating
- If there are losses inflicted on other Member States, this could potentially be in violation of the spirit, if not the letter of the Treaty
- Such losses may also harden political opposition to ‘ever closer union’ and may exacerbate MS tensions
- It is a network of bilateral loan agreements that make it possible for MS to pull out
- The fund does not have ultimate seniority over other loans
- Issuance of bonds by the EFSF might have a crowding out effect on MS bonds

Our Recommendations

While the EFSM/EFSF design is far from perfect, it can provide the basis for a good crisis mitigation tool for the euro area, particularly if policy suggestions for improving the set up are taken on board. Some of these are

- **A formalization of liquidity provision for sovereigns**: Because the IMF, the traditional provider of liquidity support for crisis mitigation is too small for most large euro area economies, the EU needs an additional vehicle to supplement the IMF's funds. We recommend that the EFSF should be made permanent to serve this purpose and its present minimum institutional structure is ideal for proving liquidity to euro area members on the back of an IMF program. The EFSM/EFSF should explicitly be only a liquidity support vehicle with clear safeguards against credit losses.

- **Preferred creditor status for the EFSF funding lines**: These safeguards can take the form of a preferred creditor status equivalent to the formalized US debtor in possession financing for working capital under the Chapter 11 bankruptcy framework or the less formal preferred creditor status conferred on multilaterals such as the IMF and the World Bank. EU Members States should formally institute changes into their domestic law so the EFSF or EFSM are treated as de jure preferred creditor at par with the similar status that multilateral organizations such as the IMF enjoy.

- **Reduce the rate of interest charged:** Since by definition the EFSF will provide support to MS in trouble, the penalty interest rate charge seems misplaced. Though a similar penalty is sometimes levied on the provision of liquidity support by central banks to the private sector, the situation with sovereign states is different enough not to justify a similar treatment. The IMF typically (as in the case of Greece) provides temporary support at a lower cost of funds. So the EFSF should provide funds at cost or at the rate at which the IMF is lending to the MS in question. A 5% interest rate in the case of Greece would simply worsen its finances.

- **The EFSM/EFSF should provide 'working capital' for crisis resolution:** As will be discussed in the next section, crisis mitigation measures are not always enough. This means that MS would sometimes need to restructure their debts. They will temporarily loose market access during this process but will still need access to funds. This is where a liquidity support facility such as the EFSF can continue to be useful by providing such funds but only under a clear legal guarantee for being first in line to get repaid should the crisis resolution process go awry.

- **The EFSM/EFSF should provide guarantees not loans (see box below):** We strongly believe that there are several advantages to the EFSM/EFSF providing bond guarantees rather than loans. A 3-5 years guaranteed bond issue program should provide enough time to deal with both liquidity and solvency problems that any MS faced. While the "guarantee over loan" change does not address the problem posed by the "no bailout clause" per se, it does avoid duplication and excessive transaction costs that are associated with the process of first issuing EFSF bonds and then making loans to MS.

  The second big advantage of a guarantee mechanism is that it is much quicker to use so in the event of a liquidity emergency, guarantees can be issued for 'new bond issuance' more or less instantaneously rather than having to wait a month which the current suggested framework of EFSF issuance/MS loans would imply.

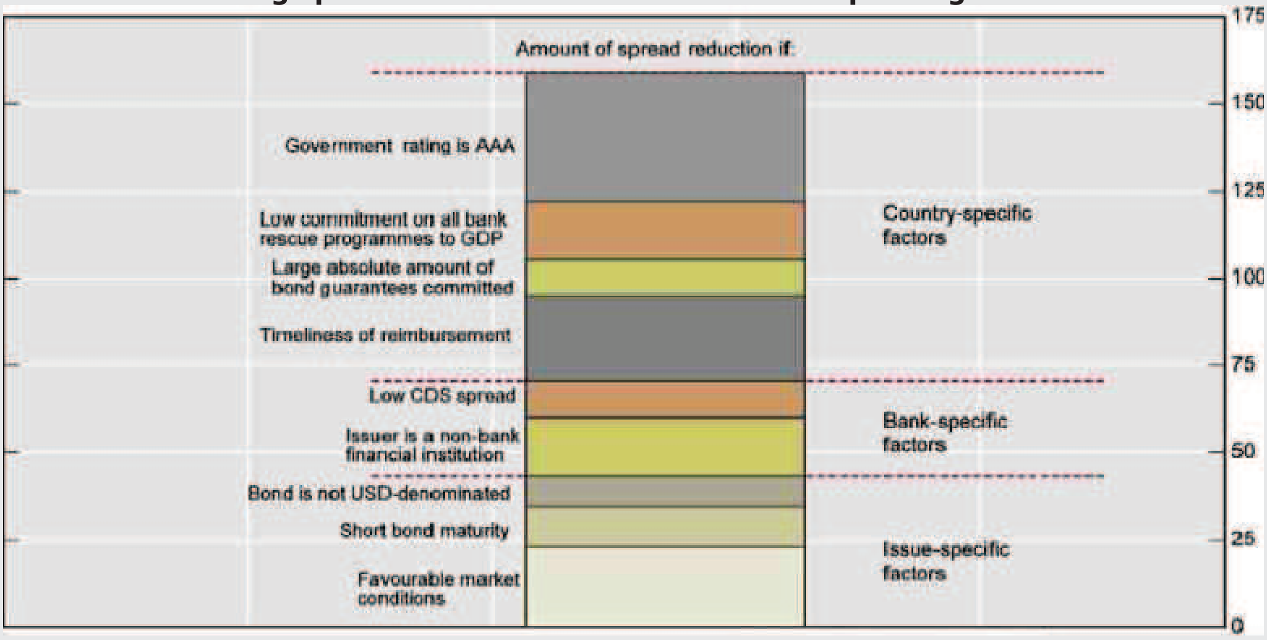
The third big advantage of a guarantee scheme is that it can help leverage a limited amount of funds. Looking at the model that MBIA and AMBAC, two municipal bond insurers in the US used before the financial crisis hit, it is clear that the EUR 60 billion EFSM could for example easily support a bond guarantee program between EUR 200 billion and EUR 300 billion in size with the EFSF capable of supporting a proportionately larger guarantee program.

The alternative, if a decision not to use leverage is taken, would still be to use the EFSF/EFSM to issue euro to euro guarantees for MS bonds rather than use outright bond issuance since it would reduce the double counting of outstanding debt for euro area MS and the market consistently under prices guarantees. This would mean that the debt statistics of euro area MS as a whole would look more favourable on paper and it is likely that the overall interest costs to euro area MS would be lower.

BOX: THE EU BOND GUARANTEE PROGRAM FOR BANKS

More than EUR 600 billion of bonds were successfully issued by EU banks under Member State guarantees, and these were very effective in stemming the crisis. This concept should be translated to sovereign bonds.

Factors influencing spreads of bank bonds issued under public guarantee in the EU



Source: "Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects?" Vox EU column by Aviram Levy and Fabio Panetta, 2009

As the previous graph shows, the most important determinant of the cost of issuing guaranteed bonds is the strength of the guarantee (the country specific factors in the graph) with the nature of the issuing entity and liquidity of the bond issue being far less important.

The governments that issue the guaranteed bonds can be forced to accept conditionalities and pay a fee that in principle can be equivalent to the current plans under the ESFM/EFSF. We suggest, however, that any fee should not be payable upfront and should only be recovered once the sovereign in trouble has recovered. So the fee should be contingent on a healthy exit, which would reduce the likelihood of a self defeating outcome where the high cost of guarantees could potentially drive a government facing a liquidity problem into insolvency.

Another advantage of these short-term guarantees is that they are self extinguishing. As funding markets improved in 2009, EU banks issued less and less of these guaranteed bonds and the guarantee automatically expires when the bond matures.

EU banks have issued more than EUR 600 billion of government guaranteed bonds since the collapse of Lehman brothers and this has been a crucial crisis mitigation and liquidity provision instrument for banks which otherwise would have potentially collapsed after the crisis reduced possibilities for reasonably priced funding.

The cost of guarantees at 0.5% for bonds can be used as a benchmark for states. UK, German and French banks all issued more than EUR 100 billion of guaranteed bonds each. At one point, in the first quarter of 2009, as much as 30% of the funding needs of European banks were met through the issuance of guaranteed bonds.

6. Crisis resolution

Crisis resolution measures are mostly about restructuring debt and defining the burden of losses, which in the case of a firm involve 1) winding up or 2) declaring bankruptcy or receiving capital injections. For sovereign states these involve the restructuring of debt liabilities, with or without a formal default.

There has been little progress on instituting crisis resolution measures in the EU so far. Work is in progress on making provisions for a predictable and fast mechanism for resolving financial institutions but crisis resolution work for sovereign debt problems in not formally on the agenda of policy makers.

EU Measures - Head in the sand

EU leaders seem to have decided to put their heads in the sand and hope that the Greek storm is temporary and will blow away. While a number of steps, as discussed in the previous section, have been taken to present liquidity support to Greece, none of them account for the possibility that the Greek sovereign debt situation is simply unsustainable. With debt levels expected to stabilize around 150% GDP, a sharp downward revision to the GDP, increasing interest rates payable and the bulk of interest payments being made to Greek bondholders outside the country, it is unlikely that Greece will able to repay its debts on existing terms.

Even if one suspends disbelief for a minute and assumes that Greece will be able to service its debts, it remains very difficult to justify why the burden should be shouldered exclusively by Greek public finances and why at least some of the burden should not fall on the private sector owners of Greek bonds. Bleeding a patient to cure him did not work in the middle ages. There is no reason why it would work now.

(There are some who say that this is the only way Greece will make the reforms that are strictly necessary for its long term vitality. That might be so. But the collateral damage being inflicted on several poorer segments of the Greek society is hard to justify. Surely there is a less round-about way of bringing this about.)

Other suggestions

Other commentators have made suggestions for putting in place debt resolution measures for the euro area in general and Greece in particular. These have in most cases involved suggestions for setting up a European Monetary Fund or a European Debt Mechanism. There have also been additional suggestions for putting in place collective action clauses (see contribution in this compilation).

However, for reasons elaborated in the next section, we do not find these suggestions to be wholly convincing though there are important aspects that can prove useful in the design of a more comprehensive crisis resolution mechanism.

Policy discussion

The EU's actions on insisting that Greece does not have a solvency problem are understandable in the context that policy makers did not want to spook the markets into a panic. However, these are ultimately self defeating and while the case for ignoring solvency issues might have been stronger in May, the sooner these are acknowledged and dealt with the better it is for all actors involved – the financial markets, Greece and the other euro area MS. Market panic has subsided for the time being and efforts should be made to refer Greece from crisis mitigation to crisis resolution treatment within the 2010 calendar year.

By refusing to acknowledge the depth of Greece's problems upfront, the EU has boxed itself into a serious corner. The longer we wait to recognize that Greece has a solvency issue, not just a liquidity problem, the bigger the burden of any eventual adjustment will need to be borne by the public sector in the EU as an ever increasing proportion of outstanding Greek debt will be directly or indirectly owed to fellow Member States. Such fiscal burden sharing would not only be politically poisonous but will also be against the spirit, if not the letter of the Treaty.

That is why Greek debt needs to be restructured, and done as quickly as possible, to enable the bulk of the burden to be shared between the Greek public sector on the one hand and the largely private sector holders of Greek debt inside and outside the EU on the other. This is primarily an issue of burden sharing between these two constituencies and should have been explicitly recognized to be so.

An increasing number of commentators have been calling for the restricting of Greek debts. There have been proposals to set up a European Monetary Fund (EMF) or a European Debt Mechanism (EDM), driven primarily by recognition to put in place a framework that would allow for sovereign bankruptcy.

However, there are already far too many institutions in the EU and the economic governance structure is already far too fragmented, so the establishment of yet another institution should be avoided to the extent possible.

Moreover, foreign governments hold more than $1 trillion of euro area government debt and would be highly uncomfortable with any EU based institution being able to assign haircuts on holdings of euro area bonds due to potential for conflict of interest. That is why any institutional structure that deals with euro area state insolvency or debt restructuring has to be international and independent from the EU.

The IMF's Sovereign Debt Restructuring Mechanism failed to win widespread support partly because it was seen to be too close to the public sector by private bond holders, and in addition it was seen as potentially conflicted since the IMF too would have exposure to sovereigns whose debts it would help restructure. The right lesson from that is again that the EU cannot depend on an EU institution for restructuring as this would not be seen to be fair by the private sector, which is expected to bear a large part of the burden of any euro area government debt restructuring.

Because both foreign governments and the private sector will bear costs of the haircuts, it is essential to have an institution that would be acceptable to them and which would be seen to be independent of excessive government influence in general and the EU influence in particular. That is why we are strongly in favour of an international mechanism for debt resolution not a European one.

Adding collective action clauses to all future bond issues in Europe has also been proposed as a measure that can help a country restructure its debts when it gets into trouble. By itself this is a good idea, but 1) it involves a long transition period and 2) restructuring even with collective action clauses involves a long and tedious negotiation process with each outstanding bond issue needing to be separately negotiated. Also, 3) it is far too dependent on the likelihood of a reasonable agreement with the majority of bondholders to be a first best solution to countries facing over indebtedness. So a formal bankruptcy or debt resolution mechanism is preferable over a solution that simply involves collective action clauses.

Our Recommendations

Changing debt contracts has significant friction costs. Messy restructuring, in particular, involves significant economic pain both for creditors and debtors, and involves large deadweight losses. That is why it would be much better to put in place a predictable and independent sovereign debt resolution mechanism ex ante so that this can play a disciplining role in crisis prevention as well and enable a more efficient and fairer burden sharing.

This is the ONLY way to deal with sovereign solvency problems of the kind faced by Greece, especially as long as the no bailout clause exists and prevents other countries from picking up the tab. This in any case would be dangerous under the current political climate, when resentment against Greece in other MS is at an all time high.

The (direct) burden sharing has to be between the public and the private sector even if this might mean that other EU governments would then face a fiscal burden in order to recapitalize their private financial sector. This would be disciplining, reduce moral hazard, give these EU governments the opportunity to assert more control on their financial institutions including by changing management and it would be technically compatible with the no bailout clause in the EU treaty.

While some discussions have suggested putting in place pan-EU debt restricting mechanism, we believe that it would be strange, perhaps even irresponsible, to put in place a mechanism that applies to the EU alone, especially when poor developing countries have been (and will be again) in far greater fiscal trouble. Under the current fiscal scenarios, it is not just poor developing countries but several other rich countries such as Iceland that are in much worse shape than most euro area countries. Plus, it risks sending negative signals to the market that it is only euro area countries that can default.

Countries in the developing world are much more likely to need restructuring of their debts to other governments, multilateral organizations and the private sector. It would be a missed opportunity and go against the principles of coherence with development policy that are part of EU policy if the sovereign debt restricting mechanism the EU supports will not be open to developing countries. This is the third reason for putting in place an international rather than an EU specific mechanism.

The international environment has changed from 2002 and the IMF might be more acceptable this time round. Failing this, the BIS may be another interesting option. Or an independent arbitration panel or legal mechanism set up under the aegis of the UN with international statutory authority.

BOX: Instituting an International Debt Restructuring Mechanism (IDRM) for Crisis Resolution

The first best choice is for the EU to revive discussions on an international sovereign debt restructuring mechanism. The IMF's proposed SDRM, the US Chapter 9 model, Paris and London club restructurings, Brady bond restructurings and several other voluntary restructurings and defaults offer a series of instructive lessons on the best design for such an international mechanism.

An IDRM:

1) should be based on principles of burden sharing contained in the chapter 9 municipal bankruptcy code of the United States

2) extensively use GDP linked bonds and Eurobonds as exit instruments

3) operate quickly targeting the timeline for a sovereign bankruptcy of less than 6 months

4) make provision for adequate debtor in possession financing

5) use an independent panel of experts who are supported by a dedicated secretariat

6) address both loans and bonds

7) cover liabilities owed to both private and public entities and

8) operate under the aegis of a respected international body with a statutory status

Source: Tackling Sovereign Debt Systematically, Re-Define, 2010

BOX: Non Default Voluntary Restructuring

A default by sovereigns will have a large friction cost that creates deadweight losses and is usually very time consuming, especially in the absence of a formal institutional mechanism to deal with sovereign bankruptcy. Developing countries such as Jamaica have successfully restructured their bonds voluntarily. Such an option should be considered for Greece especially if the political will to institutionalize a formal sovereign bankruptcy mechanism cannot be mustered.

Under such a scenario payment terms on outstanding debts that would include both bonds and loans can be changed so as to reduce the effective burden of debt without triggering formal default. This helps avoid the friction costs associated with such an event. Lengthening the maturity period and reducing the interest rate payable are the two main tools that can a country mitigate its debt burden.

Here, there are a number of lessons that can be learnt from the Brady bond restructurings of the 1970s. Issuing gold standard Eurobonds or bonds guaranteed by other EU countries or a mechanism such as the EFSF in exchange for existing Greek bonds with an implicit haircut of 30%-50% would be a good way forward. Introducing a GDP linked payment component into these new bonds would further help reduce upfront costs for Greece without damaging longer term economic growth prospects. Market surveys indicate a growing appetite for such bonds.

Source: Tackling Sovereign Debt Systematically, Re-Define, 2010

7. Conclusion

The objective of this contribution is two-fold, 1) to put forward a comprehensive crisis management framework 2) and to make policy suggestions improving the various elements that comprise this framework.

In this paper we have shown that, in order to be complete, a crisis management framework will need to have three distinct but inter-related elements 1) prevention 2) mitigation and 3) resolution. Furthermore, we have highlighted how the policy discussions in the EU on the handling of sovereign crisis have thus far focussed their attention mostly on prevention and mitigation with no serious discussion of provisions for resolution.

The paper has also exposed how the ongoing discussions on crisis prevention are based on unrealistic and flawed assumptions. We have attempted to make serious new suggestions on how to improve the crisis prevention framework within the euro area which are based on a more realistic interpretation of the political economy of policy making in the euro area.

The policy measures adopted by the EU on crisis mitigation, which is where the firepower of the ECB and the EU has been concentrated, while substantial, still have room for improvement. We have put forward a number of concrete measures that could be taken in this regard.

Finally, we provide some ideas on building crisis resolution tools as a means of completing the euro area crisis management framework.

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