How to stem the Euro Crisis?

A Policy Maker Brief by Sony Kapoor, Managing Director Re-Define, 9th September 2011

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The Euro area now has a systemic crisis. It is no longer possible to believe that the crisis is limited to the peripheral countries with Spanish and Italian borrowing costs staying high after having breached levels not seen since the birth of the Euro. August also saw questions being raised about the sustainability of French public finances and growth came to a dead halt. Germany can no longer pretend that it does not face a domestic problem now that upheavals in the Euro area have, led to a collapse in German growth.

Unfortunately many sensible things such as reducing the stock of Greek debt, forcing greater and faster recapitalization of EU banks and introducing a bigger and more flexible design for the European Financial Stability Fund and the European Stabilization Mechanism from the outset were rejected by the European Commission, the European Council or the European Central Bank, sometimes all the institutions at once.

This unwillingness and inability to make sensible choices has led us down the wrong fork in the road and is directly responsible for the crisis having morphed from being a containable crisis in the periphery to one which has now infected the core and become systemic. Enormous damage has already been inflicted on large swathes of the EU economy and will cost EU tax payers dearly. Many jobs have now been destroyed, some permanently and the handling of the crisis has done lasting and irreparable damage to the European project. It is now no longer possible to say with total certainty that the Euro itself is safe.

Up until the time that Spain and Italy got caught up in the crisis and France's AAA rating was questioned by the market in August, certain steps such as the restructuring of peripheral country debt, improving and expanding the EFSF and bank recapitalization would still have been enough to stem the panic and uncertainty that has destroyed growth and jobs in the EU, but it is probably too late for these steps to be sufficient now. For example, expanding the EFSF today could undermine the French AAA rating that underpins the EFSF's own credit worthiness. Were it not for the ECB's purchases of Italian and Spanish bonds over the past few weeks, the Euro area would have been in an even worse shape.

At this juncture, there are only two solutions that are guaranteed to work economically: 1) A bold ECB-led intervention or 2) a temporary issuance of some form of Eurobonds.

A third solution involving the EFSF such as allowing it to issue partial guarantees against first losses on troubled member state bonds that will provide a credit enhancement to these bonds could bring their costs down dramatically. Turning the EFSF into a bank with a line of credit from the ECB could

also be used. However, the crisis is now systemic and we may well be past the point where this third option of leveraging the EFSF could stem the panic.

The first solution that is both politically more feasible and efficient in the economic sense is that the ECB, setting aside its reluctant approach to buying Spanish and Italian sovereign bonds, comes out with a bold policy to do ‘whatever it takes’. The crisis now having become systemic, the ECB’s constitutional mandate as the guardian of the Euro and as the institution responsible for stability in the financial system would easily cover such intervention to normalize and stabilize the situation.

The ECB’s current approach of a hesitant approach to buying these bonds will repeatedly be tested by the market and is not sustainable. On the other hand, because the ECB has the firepower to stand behind a bold promise where it stands ready to buy whatever amount it needs to such a promise will be believed and is not likely to be tested continuously and the ECB would actually probably not need to buy as many bonds as it would under its more hesitant current approach that does not inspire confidence. Just the fact that it is able and willing to 'whatever it takes' should be enough to stabilize the market.

The fact that the US Fed, the Bank of Japan and the Bank of England stand behind and have purchased significant quantities of their national government bonds since the crisis broke out unlike the ECB which has only intervened marginally in the sovereign bond market and is not seen to stand behind Euro area member state bonds in the same way is extremely important. This is one of the major factors accounting for the reality that the Euro area continues to face serious sovereign refinancing problems unlike these three counties which have not faced similar problems despite having debt parameters that are worse than those of the Euro area aggregate. A bold intervention from the ECB will make all the difference and can easily give Member states the time and fiscal space to address longer term structural and fiscal issues away from panicked market conditions.

It will reduce the uncertainty that is hanging over the Euro area economy, help restore consumer confidence and help restart business investment. By breaking the sovereign-bank loop, wherein the perceived riskiness of sovereign bonds on EU bank balance sheets is weighting down their ability to fund themselves, ECB actions will also help restore the availability of credit. They will also open some short term fiscal space which can help slow down some of the excessively harsh austerity measures which have now triggered a low-confidence-low-growth-low-revenue trap in the Euro area in general and troubled member states in particular. Europe does not have a short term fiscal problem, but a medium and long term one. So a short-term loosening of fiscal policy can help restore confidence and growth and create space for medium term fiscal consolidation and longer term structural reforms.

So, bold intervention by the ECB is the solution that makes most economic sense, is guaranteed to stem the panic and can be brought about without the unanimous consent of a sharply divided European Council. However, the ECB has acted somewhat unpredictably and while its tough words are at least partly posturing the fact of the matter is that EU leaders cannot know for certain in advance if and whether the ECB will step up to the plate. Economic and political damage is being done to the Euro area and to the European Union every day that this crisis continues. If the ECB does not seize the initiative, it will end up inflicting unspeakable damage to the currency it is supposed to stand behind. The departure of Jürgen Stark, an ideologue and hardliner who has no place in managing the current systemic crisis, may make ECB intervention more likely.

The second solution that will work in an economic sense to stem the current market panic is at this stage a political non-starter. The Bundesbank's press campaign in Germany in late August has further hardened German attitudes both in the public and amongst policy-makers against Eurobonds to the point where even a discussion will break the coalition. The German constitutional court's decision last week has also tilted the landscape against Eurobonds for the foreseeable future.

However, unlike what the debate in the media has suggested Eurobonds are not a black and white concept but come in many shapes and sizes and it may be possible to customize them in a way that can be used for contingency planning were the ECB to fail to intervene even if the present crisis got worse.

Eurobonds can have several objectives ranging from a role as crisis bonds to a deeper role as pre-cursors to a closer fiscal union or even an EU finance ministry.

They can be issued backed by 1) callable capital (in the way that EIB bonds are) 2) member state pooled guarantees (EFSF) 3) EU legal obligations (EFSM and Balance of Payment facility and Macroeconomic assistance bonds issued by the European Commission) 4) a partial joint and several guarantee that is capped at say 200% of member state GDP 5) or in the extreme case by a full joint and several guarantee. These will also have different interest rates but will all benefit from an enhanced liquidity.

Given the recent down-grade of the United States, the search by international investors for safe assets and by emerging market central banks for reserve assets would has grown more desperate and it is almost given that a well-designed Eurobond would be exactly such as asset. This could bring down long-term financing costs not just for the weaker member states but even for stronger states such as Germany. In any case, any total reduction in Euro area member interest costs could be shared in a way that benefits all member states.

The problem of moral hazard that has so turned many countries against the concept of Eurobonds could be addressed by designing an interest rate and sanctions regime that penalizes irresponsible actions before they become systemic. This will need to include an automatic and a discretionary element with an explicit mechanism for crisis management.

Eurobonds will also help break the sovereign-bank loop permanently. Weak banks have brought down sovereign and sovereign debt that is now perceived to be risky by financial markets threatens to bring banks down. Having safe Eurobonds will allow banks to build up the new more stringent buffers of high quality liquid assets now required by the new Capital Requirements Directive and the Basel III regime without the banks needing to be concerned about the riskiness of these liquid assets.

Two of the biggest benefits will come from 1) having ECB backing for Eurobonds in the manner that US treasuries are backed by the US fed and 2) the development of a Eurobond denominated single spot and futures market that will improve EU financial market integration as well as increase its liquidity. While ECB backing is not certain, it is far more likely to stand behind Eurobonds than the sovereign bonds of any single member state. Even a partial or implicit backing in crisis times would carry great weight.

Given that the majority of the EU electorate is at this stage against Eurobonds and further fiscal union and that countries including the Netherlands and Germany stand ready to veto any discussion

of these instruments it may make sense to examine the possibility of viewing Eurobonds purely in a crisis mitigation context. The debt to GDP ratio, revenue to GDP ratio, Debt/Revenue ratio for the Euro area as an aggregate and Germany are nearly indistinguishable as the following table shows.

Debt/GDP	Deficit/GDP	Revenue/GDP	Debt/Revenue	
83,2%	-3,3%	43,3%	192,20%	**Germany**
85,4%	-6,0%	44,5%	192,10%	**Euro Area**

While the Euro area deficit is significantly worse than that of Germany, all Euro area countries (apart from Greece) are in the process of reducing their deficits and in any case the Euro area deficit remains significantly lower than that in the United States and the United Kingdom.

If the ECB refuses to blink then an indirect issuance of Eurobonds could be agreed to through the use of an institution in order to protect the integrity of the Euro area. A temporary (say 3-5 year) mechanism with a built-in automatic exit clause for the issuance of crisis Euro bonds may be easier to agree to politically than any mechanism that has a more permanent feel to it or is seen to be a move towards a fiscal union. It would work economically to stem the prevailing panic and buy time and some fiscal space to tackle the more fundamental drivers of problems in the Euro area.

For example if all new issuance of sovereign debt was temporarily in the form of Eurobonds between now and 2016 around 60% of Euro area debt would convert to these temporary crisis bonds by end 2016 totalling almost Euro 4 trillion. Italian Eurobond debt would amount to 45% GDP, Spanish 40% of GDP. No country would see its Eurobond debt level exceed the 60% GDP ratio by this time with Portugal at 55% coming closest to this limit.

The crisis can be tackled in these 5 years and fundamental fiscal and structural reform undertaken. The crisis bonds could have a maximum maturity of 4 years so as to make the crisis Eurobonds temporary and self-extinguishing by 2020. In the absence of a miracle change in public opinion and political atmosphere that could induce Euro area governments to take a decision to turn the temporary crisis Eurobonds into something more permanent, the experiment would end automatically having helped stem the crisis.

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