



Re-Define Press Statement

How to Stem the Euro Crisis, 16th September 15:00 CET

Note: Please feel free to use any parts of this Media Note, which makes for essential reading if the Euro Crisis is your thing, for Media Quotes. Please attribute any Quotes to Sony Kapoor, Managing Director of Re-Define, an Economic Policy Think Tank. Please also read our latest Policy Maker Brief [here](#).

The Euro crisis has now turned systemic. The presence of Tim Geithner at the ECOFIN meeting testifies to the global ramifications that any actions or non-actions by Euro area leaders will have and provides a perspective on how serious the problem has now become.

Yet, our leaders continue to pretend that the crisis is under control and seem to be living a parallel reality that has little, if anything, to do with the actual crisis in the Euro area. Their inability to handle the problem of Greece, one of the smaller economies in the EU does little to inspire any confidence in their capacity to tackle the much larger threat posed by the continuing failure of Italy and Spain to be able to refinance themselves at reasonable costs.

While various commentators have been pointing to the need for recapitalizing the banking system, the fact of the matter is that if Italy is not considered to be solvent, all bets are off. If Italy is insolvent, the European Banking System is bankrupt, **period**. And Italy is insolvent unless its refinancing costs can be brought down to reasonable sustainable levels, roughly down to the 3%-4% level.

So while a capital injection may be necessary, it is simply not sufficient. As of today, the main solution to the crisis lies not in action in the financial system, but putting to rest any lingering doubts on the solvency of sovereigns outside the periphery, particularly Italy.

How can this be achieved? **One idea is Eurobonds.** While it is a political dead-end now, it may resurface as the EU runs out of all other alternatives one by one. A particular version **Re-Define** has been working on, **Crisis Bonds**, that allow a temporary issuance but contain an automatic sunset clause that may be capable of squaring the circle between the need to stem the panic and buy time for a more substantial discussion on the one hand and concerns about moral hazard on the other. You will find the idea, which we have worked on for policy makers, sketched out in our [attached note](#). Please also see a couple of media pieces in the WSJ that we have contributed to [here](#) and [here](#).

A second idea is to leverage the EFSF so its uncommitted Euro 200 billion or so of funds can be stretched further, to as much as Euro 1 trillion of fire power. This is another area in which we have been advising EU policy makers.

There are a number of possibilities being discussed 1) using the EFSF to guarantee Italian and Spanish Bonds against say the first 20 % of losses (credit enhancement) 2) Allowing the EFSF to access a line of credit from the ECB by either turning it into a bank or through another mechanism 3) using derivative market operations with financial institutions so as to indirectly access ECB funds to leverage the capacity of the EFSF to purchase Italian and Spanish bonds and 4) allowing the EFSF to issue guarantees to the ECB against a first loss on further bond purchases. See two Reuters stories we contributed to [here](#) and [here](#)

All of these options work through the concentration of risk in the EFSF and all of them, apart from the first option (you can find more details on this in this Re-Define Policy Maker note from 2010 – option 4 [here](#)) make direct or indirect use of ECB liquidity.

While leveraging the EFSF was a good idea that we had strongly advocated for already in 2010 and it ought to have been effective in limiting contagion and panic, it is probably too late for this to be sufficient to stem the panic now that the crisis has turned systemic.

There are three particular issues here 1) The EFSF has a significant cost of funds – 3% or so, which may rise if it is leveraged 2) the decision making for the EFSF is unanimity based (with parliamentary approval as a consequence of the German constitutional court decision) so can be held up by any of 17 (actually more) actors 3) even with leverage the financial capacity of the EFSF would be limited.

The third option, which at present is our preferred option for action because it is the only one we believe that can still be guaranteed to stem the crisis is for the ECB to abandon its hesitant approach to bond buying that invites speculation and doubt and is becoming less and less effective in lowering borrowing costs for a bold approach.

Under this, the ECB, as the guardian of the Euro and stability in the Euro area can legitimately step in now that the Euro itself is threatened by the systemic crisis and the pretence of the normal transmission of monetary policy no longer holds. The ECB needs to come out and say that it stands ready to do 'whatever it takes' to normalize the refinancing costs for Italy and Spain and any other sovereign that gets into trouble, with no caveats.

Because unlike the EFSF 1) its cost of funds is negligible 2) it has (at least in theory) an unlimited balance sheet capacity and 3) has a majority based governance structure, the markets will surely believe that the ECB can put money where its mouth is and the panic and systemic crisis will be contained.

This can easily bring sufficient calm so the excessive and self-defeating austerity measures can be partially reversed in order to restore growth and confidence. It will also provide time for governments to act on commitments for structural reforms and by restoring confidence in the banking system will help restore the flow of credit that can support growth. There will also be time for the Euro area to have a serious and informed discussion on where it wants to go next. Euro bonds? Fiscal Union? Reversing some aspects of the market integration?

Some of the arguments here are fleshed out in **my Interview with Bloomberg** this morning and my interview with the BBC yesterday. The Bloomberg Interview can be accessed [here](#)

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