ATHENS UNIVERSITY OF ECONOMICS AND BUSINESS

WORKING PAPER SERIES 21-2013

Safeguarding the Stability of the Euro Area and the Enhanced Instruments for Crisis Intervention

Nicholas C. Baltas

76 Patission Str., Athens 104 34, Greece

Tel. (++30) 210-8203911 - Fax: (++30) 210-8203301

www.econ.aueb.gr

Safeguarding the Stability of the Euro Area and the Enhanced Instruments for Crisis Intervention*

Nikolaos Baltas

Jean Monnet Chair

Athens University of Economics and Business

*** An earlier version of this paper was presented at the Global Jean Monnet Conference 2011, on "European Economic Governance in an International Context", 24-25 November 2011, Brussels**

1. Introduction

The sovereign debt crisis in the euro area during the spring of 2010 has revealed that the monetary and fiscal policy framework of the European Monetary Union (EMU) is still incomplete. Obviously, the rules-based framework for fiscal policy created by the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) was insufficient to prevent a debt crisis despite its emphasis on keeping public sector deficits low and strengthening forward-looking budgetary planning. Moreover, once the crisis occurred and financial markets were agitated by it, it became obvious that EMU did not have policy tools to manage and resolve the crisis. In the end, the European Union responded to the crisis first by agreeing on stabilization for Greece and then by creating the European Financial Stability Facility (EFSF) that relatively succeeded in calming the markets. However, these responses were developed in an ad-hoc manner and on a temporary basis only and do not provide a sufficient basis for dealing with any possible future debt crises in the euro area.

Several proposals have been put forward for how to improve the euro area's capacity to deal with problems of excessive public debts. In order to prevent sovereign crises, the European Commission (2010) has proposed a number of measures to strengthen the EDP and the SGP. These proposals focus mainly on making the rules of the current framework more effective and on ensuring their enforcement by introducing stiffer and more automatic penalties when these rules are violated. The European Central Bank (ECB) has made proposals (2010) in the same direction and, at the same time, has called for the creation of a crisis management fund for the euro area, which might cover some lender-of –last- resort characteristics (Gianviti, et al., 2010).
The European Council of 28-29 October 2010 stated that 'Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole and invite the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect' (European Council, 2010). There are also reports that the German finance ministry has been preparing a proposal for coordinating the demands of bond holders in a sovereign debt crisis and imposing 'haircuts' on the face value of the debt of a government in financial distress. There have been several plans along similar lines, most notably by

Gros and Mayer (2010) who proposed the creation of a European Monetary Fund (EMF) aimed at both improving crisis prevention and financing a mechanism for sovereign debt resolution.

The euro area needs a mechanism for dealing with sovereign debt crises in an effective and predictable way. Even the most sophisticated and most effectively enforced set of fiscal rules will not eliminate the possibility of future debt crises in the euro area.

2. A New European Economic Convergence

Policymakers in Europe must now concentrate their action on at least three areas (Draghi, 2011):

First, they need to deliver the growth-friendly fiscal adjustments they have been committed to implement.

Second, they need to focus on the structural reforms that Europe needs in order to boost potential growth; current problems in many countries stem as much from excessive debt as from the weak economic growth expected in the years ahead.

Third, they need to agree on a thorough reform of European economic governance. The crisis highlighted some major shortcomings. Fiscal rules and procedures have proved unable to deliver prudent policies: many member states entered the crisis with an already high public debt and insufficient margins of manoeuvre. Moreover, macroeconomic imbalances were not given an adequate role in the design of EMU governance: tensions hit not only countries with problems of public finances, but also those with a high external deficit, unbalanced growth and/or a highly indebted private sector. Finally, an appropriate framework to safeguard the financial stability of the euro area in crisis situations was missing altogether.

Reform proposals have been set out in all the three areas by the European Commission and the Task Force chaired by President Van Rompuy.

Concerning fiscal surveillance, the Report of the Task Force states that "the debt criterion ... should be made operational to be effectively applied". It is well known that, while the Maastricht Treaty requires countries with high public debt to reduce it *"at a satisfactory pace",* this provision has never been effectively implemented. The Report also envisages a wider range of sanctions, both financial and political, to be applied progressively, starting at an early stage in the budgetary surveillance process, in order to strengthen the incentives to comply with the rules in good time to avoid procyclicality effects. However, the procedures remain too lengthy and largely determined by discretionary decisions by the European Council.

With regard to the surveillance of macroeconomic imbalances, the Task Force proposes an alert mechanism, based on the analysis of macroeconomic and competitiveness developments, and an enforcement mechanism that includes sanctions if a country in "excessive imbalance position" does not comply with the Council's recommendations. As the crisis showed, macroeconomic imbalances may lead to unsustainable development and dangerous spillovers to other countries.[1]

A crisis management framework has to be designed so as to ensure appropriate incentives for countries applying for financial support and for private credit markets, in order to limit moral hazard. At the end of November 2010, the Euro group agreed on the main features of a crisis management framework aimed at safeguarding the financial stability of the euro area as a whole. In particular, it has (i) stressed that assistance will be based on a stringent program of economic and fiscal adjustment and on a rigorous debt sustainability analysis; (ii) clarified that the mechanism does not represent an unconditional bailing out and that there is always a possibility that private creditors may incur losses if the country concerned does not succeed in implementing the necessary adjustment.

The reformed Stability and Growth Pact, the new excessive imbalances procedure and the Euro Plus Pact will reinforce the economic and fiscal coordination and surveillance in the euro area and ensure that any deviation from the objectives set by these instruments are recognized and addressed at an early stage. This policy of prevention will be key to the medium- and long-term stability of the euro area.

In October 2011, during the European summit, the option of having the ECB “print more euros” was, formally at least, turned down by the chancellor of Germany; consequently, a grandiose plan was put on the table: an EFSF which would have the

[1] See, for example, Giavazzi and Spaventa (2010).

capacity to mobilize considerably less than 1,000 billion euros. Establishing the EFSF and, from mid-2013, the European Stability Mechanism (ESM), will enable targeted intervention on conditions, should it prove infeasible to safeguard the stability of the euro area as a whole. Member States which benefit from the EFSF undertake considerable efforts to tackle the causes of the crisis - principally excessive public debt and a lack of competitiveness - effectively.

All the Member States of the euro area have committed themselves to swiftly reducing their deficits, achieving balanced budgets in the medium term and implementing the structural reforms required to enhance the competitiveness of their economies on a sustainable basis. Namely:

1. Strengthening the governance of the Euro area

All the decisions taken in the last year are aimed at enhancing stability and fostering growth in all Members States. In order to support this process, the euro area needs to strengthen and streamline its institutional framework to reinforce the efficiency of its decision-making process and to promote the coherence of its institutions and procedures.

2. Enhanced surveillance and integration of budgetary and economic policy

The economic and monetary union needs to be based on an even closer coordination of national budgetary and economic policies.

It should be further enhanced through the following proposals:

- All Member States of the euro area will incorporate a balanced budget fiscal rule into their national or constitutional legislation. The fiscal rule should implement the objectives of the SGP and ensure that every Member State of the euro area achieves a balanced budget as soon as possible. Therefore, it would ensure a sustained reduction of the debt ratios in the case they exceed the reference value (60% of GDP). In line with the revised SGP, all Member States of the euro area whose debt level exceeds the reference value must present an adjustment path for reducing their debt below the reference value.

- All Member States of the euro area should confirm without delay their resolve to swiftly implement the European recommendations for fiscal consolidation and structural reforms, especially as regards labor-market, competition in services and pensions policy, and adapt appropriately their draft budget.

- In line with the Euro Plus Pact, euro area Member's States should take all the necessary measures to improve competitiveness, foster employment, ensure stability of the euro area as a whole and deepen economic integration. In particular, further progress should be made on tax policy coordination to support fiscal consolidation and economic growth.

- Structural and cohesion funds should be used to support essential reforms to enhance economic growth and competitiveness in the euro area. The European Commission should automatically check to ensure that structural and cohesion funds provide the optimum support for the macroeconomic adjustment programme and be involved in the selection and implementation of projects. In the future, payments from structural and cohesion funds should be suspended in euro area countries not complying with recommendations under the excessive deficit procedure.

3. The role of the European Central Bank[2]

The role of the ECB is one of the most important issues over recent weeks and months. As things stand the ECB should not, will not and cannot provide the unlimited financial sources to the Euro zone that financial markets seem to require. At best it could ease the pressure on illiquid states, but even this depends on the legal constraints on the ECB's defined role. Alternative options such as the ECB lending to the IMF for them to stock up on sovereign debt, are preferable to direct ECB financing of states, since the IMF and banks can apply some conditions and maintain market pressure for reform, but create hazards and complications of their own without offering additional benefits.

The decisions taken at the EU summit on 8 and 9 December are unlikely to supply adequate cover for the ECB to buy the hundreds of billions of government debt of the southern countries to fulfill this role. Through its government bond buying and liquidity provision to banks, the ECB's exposure to Greece, Ireland, Portugal, Italy and Spain has reached E706bn up from E444bn in the early summer. That is a E262bn, over a 50% increase, in only six

[2] Open Europe (2011) "Briefing Note", 19 December.

months and shows how, contrary to popular belief, that ECB is already intervening quite heavily in the markets. It also highlights how the Euro zone continues to transfer risks away from private creditors to taxpayer – backed institutions. The ECB is likely to continue to keep interest rates low and continue to provide cheap credit to banks despite inflation fears in Germany.

Updated exposure of the ECB to Greece, Ireland, Portugal, Italy and Spain

ECB exposure (€m)	Greece	Ireland	Portugal	Italy	Spain	Total
Govt. Debt (SMP nominal)	60,000	18,000	20,000	135,717		233,717
Govt. Debt (SMP purchase	42,000	14,400	18,000	135,717		210,117
Bank Lending	77,758	102,940	45,539	153,200	116,211	495,648
Total	119,758	117,340	63,539	221,059	184,070	705,765

Source: ECB, National Central Banks and Open Europe calculations
For Italy, Spain and Ireland the lending figures are for 31 November 2011, while the rest are for 31 October. All data is taken from the national central bank balance sheets.

The EU summit of 8 and 9 December failed to agree a robust regime of enforceable automatic sanctions for Euro zone countries that break the bloc's budget rules (3% deficit limit, 60% debt - to – GDP ratio and the new 0.5% structural deficit limit under the so-called "golden rule"). The ECB is keen on strong budget rules and sanctions as a way to mitigate the potential for "moral hazard" that comes with large scale ECB bond buying, i.e. if given access to cheap credit from Frankfurt and relieved of market pressure, some governments may be less inclined to push for reform. The ECB is also concerned that, just as many banks around the Euro zone are now largely dependent on ECB funding to stay afloat, once a government starts to receive large-scale funding, it may be very difficult to come of it.

The ECB will conduct in the following years refinancing operations, to help banks secure longer term financing. This is widely expected, and it should help banks to secure funding and stabilise financial markets. The long term liquidity to banks will reduce the risk of a complete freeze in the funding markets in the years to come. But it is not a solution to the solvency problems facing European banks, and, without any plan to wean them off this funding in the future, it further increases the banking sector's reliance on the ECB.

Moreover a large number of commentators and investors argue that the ECB will have to engage in easing the monetary policy (including the issuance of stability bonds) as the Bank of England and Federal Reserve bank have pursued. This is considered as one of the few remaining ways out of this crisis. However, there are some questions regarding the impact of easing monetary policy in quantitative terms on economic growth in the Euro zone countries. Besides, for historical reasons Germany fears inflation will hit German savers the hardest, not simply because it is the strongest economy but due to the higher saving rate.

In sum, the ECB legal constraints, fears of moral hazard, and the lack of a clear strategy to exit the crisis, have not been tackled by the recent agreement. It, therefore, seems likely that the ECB will remain hesitant about greater intervention.

With the threat of recession in the Euro zone there was little choice but to cut interest rates by 0.25%. The reduction may relieve some pressure on the high number of individuals and households with variable rate loans and mortgages, particularly in peripheral countries.

4. Concluding Remarks[3]

In summary, it has been shown that the euro area requires:

First, a stronger commitment on the part of countries to effectively prevent the pursuit of unsustainable fiscal policies and the emergence of other harmful macroeconomic developments.

Second, if imbalances in public finances, significant losses in competitiveness or excessive macroeconomic imbalances nonetheless emerge, robust corrective mechanisms must come into force. There must be an appropriate degree of automation to ensure that these mechanisms are not open to wide interpretation or to undue political discretion.

Third, in the unlikely event that the reinforced preventive and corrective arms of the proposed enhanced framework are unable to prevent a crisis in the future, the euro area would benefit from a well-designed permanent crisis management framework.

[3] See European Central Bank (2011).

Fourth, with regard to the debt reduction, the Commission proposal must be seen as the absolute minimum, as it may not constitute a sufficient incentive for fast debt reduction for countries with high debt and relatively robust nominal GDP growth. With regard to the assessment of compliance with the debt criterion, relevant factors should only be considered when the government debt ratio declines over a three-year horizon according to the Commission's forecasts. Irrespective of whether the debt ratio is above or below the 60% of GDP reference value, when assessing whether the deficit is excessive, the relevant factors should only be taken into consideration if the deficit ratio, before taking into account such factors, is close to the 3% of GDP reference value and the excess over the reference value is temporary, in line with the current rules.

Fifth, general exemption clauses, which are proposed under the preventive and corrective arms of the SGP, should not be implemented. The application of the SGP in past years lacked the discipline needed to achieve sustainable fiscal positions before the crisis.

Sixth, greater automation is required in all surveillance procedures, including the new macroeconomic surveillance framework. When Member States fail to comply with recommendations to adjust their policies, this should lead to the consequences provided for in the preventive and corrective procedures, and the Council should have less room for halting or suspending procedures against the Member States.

Seventh, the macroeconomic surveillance framework should have a clear focus. In particular, it should focus on euro area countries with large current account deficits, significant competitiveness losses or high levels of public and private debt, as well as any other vulnerability threatening EMU. A country subject to a major recurring trade deficit necessarily experiences immense difficulties in achieving significant growth in its GDP; it just so happens that mediocre growth undermines fiscal receipts and at the same time it increases social spending.

Eighth, financial sanctions should be applied at an early stage and gradually within the macroeconomic surveillance framework to provide clear and credible incentives for countries to adopt appropriate macroeconomic policies.

Ninth, a new economic governance framework should include a crisis management framework that safeguards the financial stability of the euro area as a whole if one or more countries experience a sovereign debt crisis.

Tenth, the creation of a euro-area finance ministry, with a minister with veto rights over national budgets that could threaten euro-area sustainability. The ministry would also assess the liquidity and solvency of governments facing difficulties.[4]

Eleventh, a regulation should be elaborated and approved for the issuance of stability bonds, according to the lines indicated by the European Commission.

Twelfth, the decisions of the European Council should be implemented concerning the EFSF.

In creating a crisis resolution mechanism, Europe is taking the lead where the international community failed to find agreement a decade ago. There are good reasons to think it has a fair chance to succeed, and we do not share the view of those who claim that no European solution can be found in the absence of a global solution. By the same token, however, we certainly consider that there would be significant benefits in the definition of a global response to the sovereign crisis-resolution issue, and we hope that Europe's decision to create a regional mechanism will help advance the global discussion.

[4] See, Marzionotto Sapiz and Wolff (2011).

References

Draghi, M. (2011), “Complementarity and Coordination of Macroeconomic and Financial Policies to Tackle Internal and External Imbalances”, Banque de France, Financial Stability Review, No. 15, February, pp. 43-51.

European Central Bank (2011), “The Reform of Economic Governance in the Euro Area: Essential Elements”, Monthly Bulletin, March, pp. 99-119.

European Central Bank (2010), “Reinforcing Economic Governance in the Euro Area”, Brussels, 10 June.

European Council (2010), “Conclusions of the Meeting of Heads of State or Government”, Brussels, 29 October.

Gianviti, F., A. Krueger, J. Pisani-Ferry, A. Sapir and J. von Hagen (2010), “A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal”, Bruegel, 9 November.

Giavazzi, F. and L. Spaventa (2010), “Why the Current Account Matters in a Monetary Union: Lessons from the Financial Crisis in the Euro Area”, CEPR, Discussion Paper Series, 8008, September.

Gros, D. and T. Mayer (2010), “Towards a Euro(pean) Monetary Fund”, CEPS Policy Brief, No. 202, February.

Marzionotto, B. A. Sapiz and G. Wolff (2011), “What kind of Fiscal Union?” Policy Brief 2011/06, November, Bruegel.

Open Europe (2011), “Briefing Note”, 19 December.