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**The Future for Eurozone Financial Stability Policy**

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# The Future for Eurozone Financial Stability Policy<sup>1</sup>

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**Abstract:** The past few months have exposed serious problems in relation to Europe's ability to cope with financial stress. Placing the new Financial Stability funds on a permanent basis, in the form of a new European Monetary Fund will be required if Europe is to deal effectively with the serious debt problems of some Eurozone countries. However, this fund should exist to manage sovereign defaults in an orderly manner, not to prevent them altogether. Bank supervisors also need to publish regular stress tests, change their regulations on the risk weighting of sovereign debt and put new resolution procedures in place. Together, these reforms will allow Europe to deal with future sovereign debt problems without provoking a crisis.

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<sup>1</sup> This is a briefing paper delivered by the author to the European Parliament's Committee on Economic and Monetary Affairs in his role as a member of an Expert Panel of advisors in relation to the Committee's Monetary Dialogue with the European Central Bank.

## 1. Introduction

The sovereign debt crisis has exposed a number of serious problems in relation to Europe's ability to cope with financial stress. On May 9<sup>th</sup> a series of bailout funds for Eurozone countries were announced: €440 billion in the form of a European Financial Stability Facility or EFSF (a special purpose vehicle funded by Euro area member states), €60 billion in the form a European Financial Stability Mechanism or EFSM (funded by the European Commission) and €250 billion made available by the IMF.

While the public discussion of this decision has largely focused on the idea that the agreement was aimed at preserving the Euro as the common currency, the truth was more prosaic: The European banking system was already in a fragile state and would not have coped with a series of sovereign defaults. The need to maintain financial stability, specifically banking sector stability, was what prompted the unprecedented announcement of the bailout funds.

The announcement of the emergency bailout funds have helped to restore some stability to European sovereign bond markets, though spreads on the debt of some of the countries with weak fiscal positions, such as Ireland, have widened in recent months. In addition, the subsequent EU-wide stress test has provided some clarification of the extent to which European banks are exposed to sovereign debt, though the funding situation for many banks still remains very challenging.

Despite the progress made in the past few months in dealing with the sovereign debt crisis, we are still a long way from having permanent institutions in place that can deal with the type of crisis situations that arose this year. The EFSF and EFSM are explicitly temporary in nature, intended to expire after three years, while the IMF contingency support is also likely be available for a limited time.

In this paper, I first discuss what is likely to follow the EFSF and EFSM in relation to dealing with the sovereign debt issues. I argue that two principal approaches need to be taken. First, the temporary mechanisms should be formalised in the form of a European Monetary Fund, as proposed by Daniel Gros and Thomas Meyer. I outline how such a fund should operate, arguing that we need to be able to deal with sovereign defaults in the Euro area in an orderly manner. Second, European banking regulation and supervision needs to be strengthened with the aim of making the banking system more robust to sovereign defaults. Finally, I offer some brief comments on the connection between the current crisis and the future of the Euro as a common currency.

## **2. A Sovereign Debt Safety Net**

### ***2.1 Formalising the Safety Net: A European Monetary Fund***

Even among those who may agree that the introduction of the €750 billion bailout fund was necessary, there are going to be different opinions as to how best to proceed from the current situation.

Those who are concerned about the moral hazard implications of the bailout fund are likely to recommend taking a hard-line approach to future sovereign debt problems. This position views the recent bailout funds announcements (and actual bailout of Greece) as highly unfortunate events brought on by crisis circumstances and argues in favour of returning as soon as possible to a position in which “no bailouts” is again the prevailing position of the EU in relation to sovereign debt problems.

According to this argument, the key preparation work that needs to be done during the three years that the EFSF and EFSM are in place relates to fiscal adjustment and the reconstruction of fiscal institutions in European countries. To prevent the need for

future bailouts, this approach would emphasise that the key priorities for the next few years are:

- (a) The adoption of budgetary adjustment plans that put all Eurozone countries back on the path to fiscal stability.
- (b) A new tougher approach to monitoring of national budgets by the EU Commission.
- (c) The introduction of improved national budgetary institutions which will see a greater role for external assessment and for fiscal rules.

There is an important ongoing debate within the various European institutions about how to achieve these improvements in budgetary management with many good ideas being discussed by the van Rompuy task force. It is to be hoped that improved institutions will indeed deliver a more sustainable fiscal future.

It would be unwise, however, to believe that improved fiscal rules will allow us to rule out the possibility of severe fiscal problems arising in one or a number of Eurozone countries, so that the EFSF and EFSM can simply be allowed to expire without providing a replacement. There are a number of reasons for this:

- (a) A number of European countries are in precarious fiscal positions and adjustment plans are likely to take a number of years. Thus, it is unlikely that those European countries currently under threat will be restored to fiscal stability by 2013.
- (b) The health of the European banking system remains in question. The most likely trigger for sovereign defaults in the next few years is a prolonged period of slow growth or perhaps a double-dip recession. Should this occur, it will also have a negative effect

on the capital position of the banking system and this would lead to the reoccurrence of the joint sovereign\banking problems that have emerged this year. In other words, we cannot assume that future fiscal problems will occur against the background of a strong banking system, which could allow for a more hard-line “no bailout” approach.

For these reasons, preparations should be made to formalise the EFSF and EFSM into a single fund to assist Eurozone countries that are having difficulty with sovereign borrowing. In line with the proposals by Daniel Gros and Thomas Meyer (2010) which were circulated prior to the events of May this year, I will refer to this fund as a European Monetary Fund or EMF.

## ***2.2. Mechanics of a European Monetary Fund***

How would an EMF work in practice?

### *Loan Distribution*

In terms of its key job of making loans to European countries that are shut out of sovereign debt markets, the detailed framework agreement for the European Financial Stability Facility provides most of the ingredients for what appears to be a workable model that can be taken up by a future European Monetary Fund that is put on a permanent basis.

In relation to the decision to administer a loan from the EMF to a European country, the loan application should trigger a process in which the European Commission and the EMF analyse the country’s economic and budgetary position and agree a fiscal adjustment program that must be adhered to if the loan program is to be maintained. This program can then be recommended to the Eurogroup of finance ministers who make the final decision on making the loan.

### *Staffing and Ongoing Monitoring*

The EMF should be well enough staffed to be able to deal with emergency requests and the associated negotiations about fiscal adjustment in a timely manner. This raises the question, of course, of how to maintain a high quality and motivated staff for the EMF given the likelihood that its loan-making services are probably not going to be used most of time. The answer to this is that the EMF should be centrally involved in the ongoing (and improved) process of monitoring of national budgets under the Stability and Growth Pact. Up to now, this process has been handled by the European Commission. However, if an EMF is to be the organisation charged with helping out European countries in severe financial trouble, then it will be necessary and appropriate for them to maintain an ongoing engagement with each country that is eligible to obtain loans from the fund.

### *Financing*

The EFSF also provides a clear model for how the EMF can be financed. Eurozone countries provide guarantees that allow for a Special Purpose Vehicle to be over-collateralised and thus be AAA rated. The SPV can then borrow on the bond market and lend the funds to applicant countries at a higher rate, reflecting the potential default risk. Any profits made from these transactions can then be retained to further capitalise the fund.

Of course, while the EFSF's structure is an obvious model for the initial capitalisation of the fund, one can imagine other ways to finance the fund on an ongoing basis. Gros and Meyer have proposed that the fund be financed in a way that acts as an ongoing incentive for countries to comply with the guidelines of the Stability and Growth Pact. Specifically, Gros and Meyer recommend that participating countries should contribute a fraction of each percentage point of GDP for which their debt-GDP ratio exceeds 60

percent and another fraction for each percentage point of GDP for which their deficit exceeds 3 percent.

The Gros-Mayer proposal suggests a mechanism for financing an EMF that would also help to reduce the likelihood that the fund is called upon. As a solution to an economics optimisation problem, it is both clever and efficient. However, I suspect it would prove very difficult to get this particular proposal implemented in practice. Governments in countries that currently have high debt ratios are likely to feel under enough pressure to get their fiscal houses in order over the next few years, so this additional pressure would be likely to be very unwelcome. Also, while the proposal may be politically popular in those countries with relatively low debts, it would be extremely unpopular in high debt countries. Insisting on such a proposal may end up undermining the continuation of the current bailout funds in a new guise.

Another question about this financing proposal is whether it would require a new Treaty. The current structure of the EFSF did not require any legal changes to the European Treaty as it is justified by Article 122 of the current consolidated Treaty on the grounds that it allows emergency help to a country facing “severe difficulties caused by natural disasters or exceptional occurrences beyond its control”. For this reason, it would not appear that putting the facility on a permanent basis would necessarily require a new Treaty. However, it seems more likely that binding arrangements in which Eurozone countries are mandated to make specific contributions to an EMF based on their current debt and debt levels would require a new Treaty.<sup>2</sup> If this was the case (and I am not a legal expert, so it may not be) it would seem unlikely that such a Treaty could survive the complex ratification process.

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<sup>2</sup> This situation may change depending on the outcome of the German’s Constitutional Court’s examination of this issue.

### ***2.3. Allowing for Orderly Default***

If the current bailout arrangements are to be formalised, an important question that arises is exactly what precedent has been set by the decisions made in May 2010. One potential interpretation is that the establishment of the EFSF has meant that the EU is committed to the principle that no Eurozone member state can default. Indeed, much of public discussion in the run-up to the May 9th announcement focused on the idea that it would be unthinkable for a Eurozone country to default on its sovereign debt. The idea that the Euro is more than an economic construct but part of a greater political project is commonly mentioned to justify the need to avoid default by a member country: Euro membership, it is often argued, brings with it an obligation of all members to prevent a default on the part of their partners in the monetary union.

#### *The Need for Potential Default*

While the idea that default by a Euro area country is unthinkable is commonly expressed, not least by leading politicians and central bankers, this ambition is too far-reaching and is unlikely to be achieved. Instead, I believe the more credible approach is the one that has been stressed by leading German politicians, most notably Wolfgang Schauble, which is to emphasise the need for procedures to manage default by a Eurozone country in an orderly manner.<sup>3</sup>

Greece is likely to provide an early testing ground for an EMF's approach to the question of sovereign default. The Greek adjustment plan is an ambitious one, with very large adjustments required to bring the budget deficit back towards the 3 percent range by 2014. However, this plan can hardly be considered a final solution to Greece's fiscal problems. The plan envisages Greece having a debt-GDP ratio in 2013 of 149% and with a flow of debt interest payments of over 8 percent of GDP. At that point, however,

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<sup>3</sup> Jacques Melitz (2010) has also presented a strong case for the need to allow for possible sovereign defaults in the Euro area.

Greece's primary balance will be in surplus. Faced with a huge debt burden but with the ability to survive without new net borrowing, the Greek government will have a strong incentive to consider restructuring its debt and, ultimately, this will be a national decision.

The role of an EMF should not be to prevent a sovereign default or debt restructuring but rather to ensure that it occurs in an orderly manner that minimises disruptions in the defaulting country as well as knock-on effects on other sovereign borrowers and financial markets. Disruption to economic activity within the defaulting country can be achieved by the provision of loans to the government that is restructuring its debt, assisting it up until the point where it has regained credibility with private bond markets.

### *Mechanics of Default*

In relation to minimising the impact on financial markets, Gross and Mayer have proposed that the EMF would set the terms of a restructuring, taking over all of the defaulting country's sovereign debt at a haircut set at a level that is designed to avoid financial system instability. This strikes me as perhaps too deep an involvement for the EMF.

It is likely that an EMF will be a key creditor for countries that are facing default: Countries in this situation will almost certainly already have significant loans from the EMF. However, the EMF's debt is likely to only have the same status as other sovereign debt. In an interview with Dow Jones Newswire, EFSF Chief Executive Klaus Regling confirmed that "Unlike the IMF, the EFSF will not be a preferred creditor. It will have the same standing as any other sovereign claim on the country, *pari passu*."<sup>4</sup>

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<sup>4</sup> See [www.efinancialnews.com/story/2010-07-19/klaus-regling-explains-the-eu-stability-fund](http://www.efinancialnews.com/story/2010-07-19/klaus-regling-explains-the-eu-stability-fund)

If this precedent is followed, then the EMF can play a key role in debt restructuring negotiations by indicating the terms of the haircuts that they see as appropriate for their loans. However, ultimately, the outcome of these negotiations should involve the government of the defaulting country, private sector creditors as well as the EMF. I would not recommend that the EMF take over all claims against the defaulting country by means of offering a haircut that is more generous to bondholders than they would obtain in bilateral negotiations with the defaulting government.

An important long-run benefit of a Greek default is that it would allow a future role for bond market monitoring of national sovereign debt risk. If bond market participants understand that Eurozone sovereign debt can still be defaulted on despite the existence of an EMF, then we are likely to see the markets pay close attention to ongoing fiscal developments in high debt countries. We would also likely see a continuation of higher spreads on peripheral Eurozone sovereign debt than prevailed prior to the current crisis: This would provide a market-based incentive for countries to reduce their debt levels, as markets would reward countries that get the fiscal houses in order with lower borrowing rates.

In emphasising the need for a framework for orderly defaults with realistic haircuts, I am aware of course that the EMF will have to take financial stability considerations into account. There can be little doubt that a series of sovereign defaults with large haircuts would have caused severe financial stability problems during Summer 2010 given the current weak state of the European banking system. However, as I discuss below, it is important that the next few years see an improvement in European bank capital levels and also the introduction of efficient resolution regimes for failed banks. Together, these steps will help to minimise the “collateral damage” of a future default.

### *Implications of Defaults for Political Support for Europe*

Finally, what of the idea that a sovereign default would undermine support for the Euro within the defaulting country? I think it is far from clear that this would be the case.

A debt restructuring may be associated with a painful fiscal adjustment program and may also be a cause for national embarrassment. However, if a country's government has reached the point where default is being considered, then it is likely that the alternative approach of soldiering on under a huge debt burden will also be very painful. Even if the EU could somehow ensure that a country in this situation did not default (and it's not clear that it can ensure this) it would be unlikely that the citizens of the country would be grateful to the EU (or the euro) for facilitating this outcome.

### **3. Improved European Banking Supervision**

The Financial Stability referred to in the EFSF and EFSM relates largely to the stability of the European banking system. Uncertainty about the exposures of European banks to distressed sovereign debt has made funding conditions difficult for banks throughout Europe. The need to avoid the type of financial meltdown that accompanied the Lehmans default of 2008 was the principle motivating force behind the establishment of the bailout funds.

In addition to the permanent establishment of a European Monetary Fund, the other key direction in which policy needs to adjust is the improvement of the supervision and regulation of the European banking sector to avoid a repeat of the situation that arose this year. One clear requirement is for an increase in bank capital ratios and an improvement in capital quality. This development will make the whole banking system more capable of coping with losses of any sort. It is to be hoped that the ongoing Basle 3 negotiations will see some steps taken in this direction, though it is disappointing to

see proposals for tougher regulation apparently being consistently watered down in the negotiations.

In addition to higher capital ratios, there are three areas where I believe there is a need for new approaches.

### *Stress Tests*

One of the key problems that generated the financial tensions that begun in 2007 and rapidly worsened after September 2008 was the uncertainty about the size of the holdings by various banks of subprime mortgage backed securities as well as uncertainty about the value of the cashflows underlying these complex securities. Sovereign bonds are not complex securities but banks can sometimes be restrictive in relation to public disclosure of the composition of their sovereign bond holdings and uncertainty about these holdings was a factor in the recent period of financial turmoil.

For this reason, the stress tests performed by the Committee of European Banking Supervisors (CEBS) in July were a useful exercise. They clarified the extent of sovereign bond holding of various types across Europe's leading banks. The particular "stress test" applied was not, however, particularly stressful. Most sovereign bonds are kept on "banking books" as opposed to "trading books" for accounting purposes. With the short time horizon examined (only up to 2011) and the assumption of no sovereign default during this period, the CEBS exercise did not provide an accurate picture of the exposure of the European banking system to a true stress scenario in which there are sovereign defaults.

That said, the exercise did help to get enough information into the public domain to allow others to perform more accurate stress tests: For example, both Citibank and the

OECD have released analyses that indicate the full scale of the exposures to sovereign debt and they clearly illustrate that such defaults would trigger serious problems.<sup>5</sup>

These stress tests should now become a regular event, occurring at least once a year. In addition, it may be a good idea to hand responsibility for the design of the stress test over to the new European Systemic Risk Board. Hopefully, these exercises will become more honest about the likely outcome of stress scenarios if placed in the hand of a body charged with preventing systemic financial instability.

### *Regulatory Treatment of Sovereign Debt*

One reason that banks hold sovereign debt is that the Basle capital adequacy rules deem them to be a very low risk and thus allow banks to increase their leverage. Indeed, the Basle 2 rules allow sovereign debt rated above AA- to carry a risk weight of zero while similarly rated corporate bonds have a risk weight of 20%.<sup>6</sup> Similarly, government bonds rated from A+ to A- to have a risk weight of 20% while similarly rated corporate bonds have a risk weight of 50%. This regulatory approach can mean that banks that have considerable holdings of sovereign bonds may appear to be well capitalised but are, in fact, highly vulnerable to sovereign defaults. Whatever emerges from the Basle 3 negotiations, European regulators should end this asymmetry between the regulatory treatment of sovereign and corporate bonds.

In addition, regulators should enforce strict limits on the extent to which banks hold the debt of their own country's government. The tendency to hold large amounts of local country debt may be due to the continuation of long-standing practices that pre-date EMU. It is also likely that, in recent years, there has been pressure on banks that have been helped by government bailouts of various kinds to respond in kind by providing

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<sup>5</sup> See Citibank research note of 26 July 2010 "European Bank Stress Tests: Delight in Details, Headlines Underwhelm" and the OECD paper by Blundell-Wignall and Slovik.

<sup>6</sup> See page 19 of BIS (2006) for the sovereign bond figures and page 23 for the corporate bond figures.

funding for their sovereign. However, this is a dangerous practice from a financial stability perspective: These bonds are a particularly poor “hedge” for banks because they are likely to default during periods when the rest of a bank’s balance sheet is also deteriorating due to poor local economic conditions.

### *Recapitalisation and Resolution Regimes*

Finally, just as the best approach to sovereign default risk is to accept that every so often countries will default, the best approach to handling the financial stability implications of such a default is to accept that, despite regulators best efforts to ensure that banks are equipped to cope, some European banks will get into severe trouble when such defaults occur.

Europe needs to have an agreed set of rules as to how to deal with failing banks, so as to avoid a repeat of the spectacle of late 2008’s ad hoc patchwork of liability guarantee and recapitalisation programs. Two sets of policies need to be developed: Policies for dealing with systemically important banks that are becoming undercapitalised and policies for dealing with failed banks.

On recapitalisation, I am inclined to support Willem Buiters’ call for a pan-European Financial Institution Recapitalisation Fund (FIRF), funded by national governments and perhaps also by taxes on financial activity.<sup>7</sup> This fund could work hand in hand with a new tougher approach to bank capital standards. Large European banks that fail stress tests could be given the choice of raising capital externally or accepting equity investment from the FIRF. The terms of these investments and the policy on subsequent sales of equity shares would be standardised and designed to maximise a return for the fund.

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<sup>7</sup> See Buiters’ Citibank Global Economics View paper “Sovereign Debt Problems in Advanced Industrial Countries”.

In some cases, however, banks may turn out to be insolvent and recapitalisation by the FIRF would be a poor use of taxpayer funds. In this situation, it is important that regulators intervene once capitalisation falls below a certain level and put the bank into resolution regime, which sees the banks creditors compensated in accordance with their seniority. The legal structure for such a regime could follow the Special Resolution Regime established in the UK.

Depending on the financial stability situation prevailing at the time, regulators can decide whether or not public funds should be provided to compensate senior bond holders and other providers of longer-term funding. However, it is important that there be agreement that providers of Tier One capital (equity and subordinated bond holders) are not compensated. If providers of risk capital to large European banks believe that there are limits to how much downside risk they will have to take on, then the cycle of excessive risk taking by banks followed by banking system failure, is likely to continue.

#### **4. Financial Stability Is Not “Saving the Euro”**

Finally, I think it is important to put this discussion into some perspective and to understand what is, and what is not, at stake in relation to these proposals.

It is important that Europe put in place a framework for dealing with severe fiscal problems in its member states. Disorderly sovereign defaults, perhaps combined with the need to reduce a budget deficit to zero, can cause unnecessary trouble for the defaulting country's citizens. They can also cause serious problems for financial institutions inside and outside the defaulting countries and the recent global crisis has painfully provided more evidence for how financial instability can trigger serious disruptions in the real economy.

For all of these reasons, Europe needs to implement some serious institutional reforms in the area of budgetary policy, emergency assistance for distressed sovereigns and banking sector stability. These reforms matter for all EU countries, not just the members of the Eurozone. However, because Eurozone members do not have the option of devaluing, they are more likely to fall victim to sovereign debt and financial stability problems in the face of a severe recession.

In this sense, the reforms that are under discussion need to be implemented if the Eurozone is to maintain financial and fiscal stability. However, the continued use of overheated language about “saving the Euro” or even “supporting the stability of the Euro” is, in my opinion, inaccurate and unhelpful. Eurozone countries that experience a sovereign default are not, in fact, likely to leave the Euro after the default. The series of practical problems associated with unilaterally issuing a new currency and then devaluing it (see Eichengreen, 2007) are such that it is unlikely to be considered as an option by defaulting countries.

The Euro may still break up, however, if it becomes unpopular with the public in core countries such as France and Germany. If new institutions such as a European Monetary Fund are seen institutionalising bailouts to less disciplined Eurozone countries, they may play an important role in undermining the Euro. Those who support these new institutions will need to ensure that they are well designed if they are to improve, rather than damage, the Euro’s chances of survival as a common European currency.

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