Is the eurozone stepping back from the brink? This might just be possible, because the emerging outlines of a new framework to resolve the ongoing sovereign debt crisis contain a key component that was missing so far. Indeed, that component’s absence was behind this summer’s spreading financial crisis, which moved beyond small, peripheral countries like Greece, Ireland and Portugal to strike systemically important countries like Italy and Spain.

The starting point of the contagion was investors’ realisation that Europe’s rescue fund, the European Financial Stability Facility (EFSF), was designed to provide emergency financial support only to the peripheral countries. It simply does not and will never have sufficient funds to undertake the massive bond purchases required to stabilise the debt markets of large economies such as Spain and Italy. The EFSF will have at most €440 billion at its disposal (any increase would endanger France’s AAA rating), while the combined public debt of Italy and Spain is more than €2 trillion.

In early August, the domino effect of the eurozone periphery’s sovereign debt crisis started to kick in, because financial markets do not wait for country after country to be downgraded. Instead, they tend to anticipate the endgame, or at least one potential scenario, namely the unravelling of the entire crisis-containment structure.

Markets noticed that the euro seemed caught between a rock (the EFSF’s limited borrowing capacity) and a hard place (the European Central Bank’s great reluctance to engage in large-scale purchases of financially troubled governments’ bonds). It later turned out that the ECB was not that hard after all, although it emphasised that it would stop intervening as soon as the new EFSF became operational. And, given the EFSF’s limited firepower, the market would have been left without support.

To state the problem more generally, the eurozone requires a liquidity backstop for its fiscal authority. In a ‘normal’ economy with its own currency, the fiscal authorities can never face a liquidity shortage, because the government can always rely, at least potentially, on support from the central bank. A eurozone government, by contrast, is always in a precarious situation: it has only very long-term assets (its taxing power) and shorter-term liabilities, namely government debt, much of which has to be rolled over annually. If investors refuse to buy the country’s debt on any terms, even a fiscally prudent government could find itself in a liquidity squeeze and become insolvent.

Similarly, banks have short-term liabilities (deposits) and long-term assets, which they cannot liquidate quickly without incurring great losses. This is why all countries provide emergency liquidity support when a bank run materialises, as was done on a global scale when confidence in the banking sector collapsed alongside Lehman Brothers in 2008.

Likewise, the eurozone needs a mechanism to confront runs on its member countries’ government debt. This requires that fiscal authorities have access to a large pool of liquidity in an emergency. Only the ECB can provide this insurance.
The good news is that a solution is now slowly taking shape that promises to create a mechanism by which the ECB could backstop the EFSF. This could be achieved simply by registering the EFSF as a bank, which would give it access to normal ECB refinancing on the same terms as other normal banks. The EFSF could then conduct very large purchases of government debt by leveraging up its limited capital through ECB refinancing, using the government bonds it is buying as collateral.

In this way, the proper division of labour could be established. The EFSF would be responsible for dealing with fiscal crises in member states. For countries with solvency problems, an adjustment programme like those for Greece, Ireland or Portugal would be appropriate. But, for large countries facing a liquidity shortage, the EFSF could rely on support from the ECB.

If investors know that a liquidity squeeze is no longer possible, they will refrain from speculative attacks on solvent countries. The near-panic conditions in financial markets eased as soon as rumours spread that this solution had at least been discussed behind closed doors. It now needs to be implemented.

As always in Europe, there are legal and political obstacles to change. But even the most reluctant policy-makers recognise that the cost of inaction is too great. The legal obstacles to potential ‘monetary financing’ of the public sector in the European Union’s governing treaties can be overcome. The more important obstacle is Germany’s reluctance to admit publicly that ECB liquidity support for government debt markets can be crucial in maintaining financial stability.