EuropEos

Commentary

Eurozone Debt Crisis: Reckless debtors or misguided rescuers?

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Our disgraceful leaders have done it again: they managed to deeply unsettle financial markets by once again sparking off doubts on the orderly rollover of distressed sovereigns, pushing interest spreads over German Bunds to unprecedented heights – over 2300 basis points for Greek sovereigns – and raising fears of contagion spreading not only to Spain and Italy, but reaching the eurozone core, starting with Belgium.[1]

Two features in the public discussion stand out for their especially damaging effects. The first one is old stuff: it was clear from the start that Greece's adjustment programme was not feasible and that the Greek government would not be able to regain access to private markets for its funding. In less than a year Greece has managed to cut its public deficit to 10.5% of GDP, i.e. by some 5 percentage points, but has missed the 8.1% programme target, owing in part to a steeper than expected fall in economic activity, and is now deciding additional measures needed to meet the 7.5% target for the current year, as well public asset sales of up to €50 billion. Meanwhile, there is a consensus among experts that it will need some €66 billion in additional financing to refinance maturing debt.

This fairly predictable scenario has been read in Germany as proof that Greeks can't be trusted; additional financing is dubbed in public discussion as 'more bail-out money' and will need to be approved by an increasingly restive Bundestag. Similar sentiments are fed by populist political parties in the other eurozone creditor countries. No matter that so far there has been not a single penny of fiscal transfer from creditor to debtor countries in the eurozone, and no such transfer is being contemplated. Public discourse tells a different story. And, in order to appease disgruntled electors in creditor countries, financial assistance programmes must include punitive conditions that can't be met.

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[1] S. Micossi, "The eurozone in bad need of a psychiatrist", Voxeu.org, 9 December 2011.

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Meanwhile, in Greece social resistance to wage and expenditure cuts is escalating, together with anti-German and anti-European feelings. In sum, we are back to the bitter recriminations that one year ago preceded approval of the Greek emergency assistance: which only stopped when everyone realized that the alternative to rescuing Greece was a much worse, indeed disastrous outcome. It is a safe bet to predict the same outcome this time, of course with permanently higher financial and political costs for all the parties involved.

The novel feature is open confrontation between eurozone creditor governments and the ECB on the possibility of some kind of – even 'soft' – restructuring of Greek sovereign debt. The latest step was the open threat by ECB executive board member Jürgen Stark to stop accepting Greek paper as collateral in ECB refinancing operations if anything of that kind were to happen. Only a few days later, Lorenzo Bini Smaghi, another ECB executive board member, referred to an even voluntary debt rescheduling involving no principal writedown as "devastating for overall financial stability". An influential market analyst responded to this latter statement as follows: "All this strikes us as very odd, since all [such voluntary restructuring] could do is *help* (his italics) Greece. We are going to take Bini Smaghi at his word however, and hold off on making a reentry into these markets [for Greek sovereigns], as his comments suggest a very large problem without an apparent solution."

Direct ownership of distressed debt by the ECB is not the biggest concern: outstanding securities in the ECB balance sheet under the securities market programme amount to €75 billion, out of which some €40 billion are Greek government debt. The larger problem is the burgeoning exposure of the Eurosystem to the PIGS through its bank refinancing operations. At the end of March 2011, the total claims of the Bundesbank vis-à-vis the Eurosystem were around €330 billion (€177 million at the end 2009), roughly corresponding to the net liabilities of Ireland, Greece and Portugal and Spain. As of the same date, lending by central banks to their domestic banks – which are in turn the main holders of government debt – was 54% of GDP in Ireland, 38% in Greece and 23% in Portugal.

Thus, the first victim of debt restructuring would be the ECB and the Eurosystem. A haircut in any form on distressed sovereign debt would heavily hit banks' balance sheets, with immediate reverberations on the Eurosystem possibly triggering demands for fiscal support from national Treasuries and putting in jeopardy the system's independence. Our monetary authorities have pretended that the Greek and Irish debt crises were temporary liquidity crises, while the problem was one of solvency; as a consequence, they have placed an inordinate burden on the ECB. Now, in order to protect itself and the Eurosystem, the ECB is raising walls that financial markets will test with increasing virulence until they fall, as their foundations are flimsy. While the operational limitations that have been placed on the European Stability Mechanism (ESM), and its current predecessor the European Financial Stabilization Facility (EFSF), ensure that the ECB cannot unload its balance sheet of sub-standard paper without destabilising the eurozone financial system.

Thus, the difficulties that have emerged with the Greek financial assistance programme are an accident, and not the central issue: the same is bound to happen again with Ireland and Portugal, each time with higher risks that the fabric of cooperation within the eurozone will tear irreparably. What we must see is that there are serious flaws in the design of our crisis management system that periodically push us back to the brink of financial meltdown of the eurozone. In order to fix them, crisis management arrangements and the design of the ESM decided in March by the European Council must be changed notably in three respects.

Firstly, there is a need to circumscribe direct political involvement of the eurozone member states in individual crisis management decisions and monitoring of implementation, so as to isolate these decisions from domestic political discussions. This requires in turn that operational decisions on individual programme design are entrusted to the executive board of the ESM, under rules and procedures similar to those of the IMF – of course, following clear guidelines established by the Ministers of Finance of the eurozone, but not under direct instruction from them.

Secondly, it also requires rescinding the direct link that has been established between the decision to offer financial assistance to a eurozone member state and the national budgets, and let the ESM borrow freely as needed to restore financial viability of distressed debtors. This is the only way to overcome the 'foreign currency' syndrome that is at the root of mounting financial instability within the eurozone.[2] The institutional model already exists within the Union, e.g. the European Investment Bank (EIB). As for the EIB, the ESM should be adequately capitalized and allowed to issue Union bonds, with no explicit quantitative ceiling, but a clear mandate to act as needed to preserve the eurozone financial stability. The bonds would be issued under the joint and separate guarantee of the member states. Solid design of financial assistance programmes, with adequate conditionality, would make sure that the guarantees would not be called upon except in extreme circumstances; in ordinary circumstances the ESM would never lose money, let alone become the vehicle for fiscal transfers to the beneficiary country. The financial assistance programme would also include, as required, provisions on debt sustainability, private sector participation, bail in clauses and the like.

And, thirdly, the ESM must be entrusted with the operational flexibility required to ensure the success of its financial assistance programmes: including purchasing distressed debt in the secondary market (operating through an ECB account); swapping distressed debt with its own (Triple A) securities, as in Gros & Mayer (2011);[3] and providing its own securities as collateral in debt refinancing operations after restructuring, as in the US Brady plan at the end of the 1980s.

Of course, no such operation would take place until a financial assistance programme was in place. And the ECB should be freed of all non-monetary support tasks in addressing debt crises of eurozone members, and indeed be allowed to unwind its present exposures to distressed sovereign debtor countries by ceding them to the ESM (who would issue Union bonds to finance them).

These arrangements should be immediately applied to existing financial assistance programmes under a new mandate by the European Council to the EFSF, the Commission and the IMF.

[2] De Grauwe P., "The Governance of a Fragile Eurozone", CEPS Working Document No. 346, May 2011.

[3] Gros D. and T. Mayer, "Debt Reduction without Default?", CEPS Policy Brief No. 233, February 2011.