Financial Assistance in the Euro Zone : Why and How?

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The need for financial assistance in the euro zone

When entering the monetary union, member countries lose their capacity to issue debt in a currency over which they have full control. As a result, a loss of confidence on the part of investors can drive the country in a self-fulfilling way into default (Kopf 2011). The reason why this happens can be described as follows. Suppose that investors fear a default, by say, the Spanish government. They sell Spanish government bonds, raising the interest rate. The investors who have acquired euros are likely to decide to invest these euros elsewhere, in German government bonds, for example. As a result, the euros leave the Spanish banking system. Thus the total amount of liquidity (money supply) in Spain shrinks. The Spanish government experiences a liquidity crisis, i.e., it cannot obtain funds to roll over its debt at reasonable interest rates. In addition, the Spanish government cannot force the Bank of Spain to buy government debt. The ECB can provide unlimited liquidity, but the Spanish government does not control that institution.

This is not the case for countries capable of issuing debt in their own currency. Let's trace what would happen if investors were to fear that the UK government might be defaulting on its debt. In that case, they would sell their UK government bonds, driving up the interest rate. After selling these bonds, these investors would have pounds that most probably they would want to get rid of by selling them in the foreign exchange market. The price of the pound would drop until somebody else would be willing to buy these pounds. The effect of this mechanism is that the pounds would remain bottled up in the UK money market to be invested in UK assets. Put differently, the UK money stock would remain unchanged. Part of that stock of money would probably be re-invested in UK government securities. But even if that were not the case and the UK government cannot find the funds to roll over its debt at reasonable interest rates, it would certainly force the Bank of England to buy up the government securities. Thus the UK government is ensured that liquidity is available to fund its debt. This means that investors cannot precipitate a liquidity crisis in the UK that could force the UK government into default. There is a superior force of last resort, the Bank of England.

This different mechanism explains why the Spanish government now pays 200 basis points more on its ten-year bonds than the UK government despite the fact that its debt and deficit are significantly lower than the UK ones. This contrast is shown vividly in Figures 1 and 2.

Because of the liquidity flows triggered by changing market sentiments, member countries of a monetary union become vulnerable to these market sentiments. These can lead to "sudden stops" in the fund-

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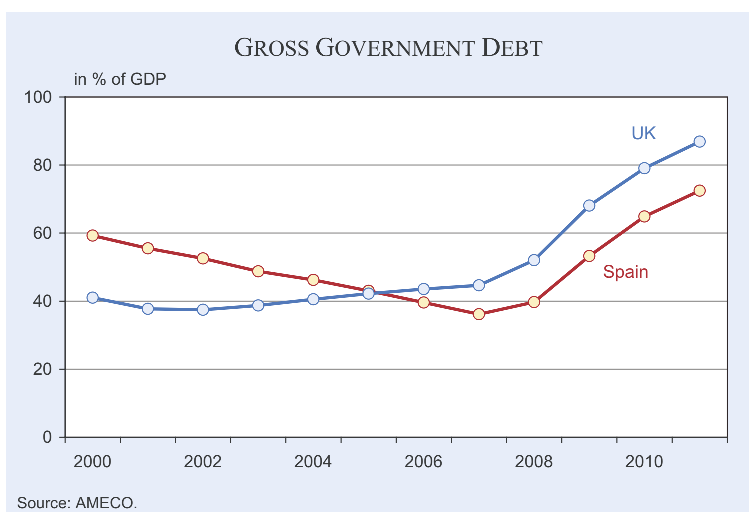
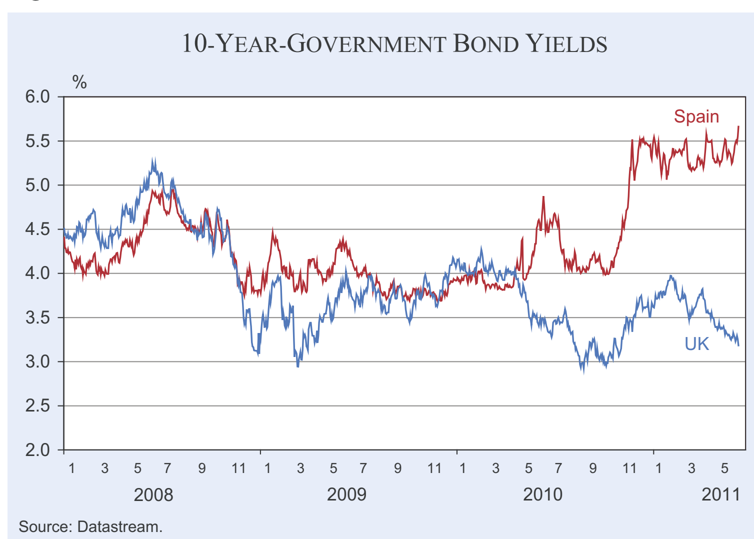
Figure 1



Source: AMECO.

Figure 2



Source: Datastream.

ing of the government debt (Calvo 1988), setting in motion a devilish interaction between liquidity and solvency crises. For the liquidity crisis raises the interest rate, which in turn leads to a solvency crisis. This problem is not unique for members of a monetary union. It has been found to be very important in emerging economies that cannot issue debt in their own currencies. (See Eichengreen et al. 2005, who have analyzed these problems in great detail).

There are important further implications of the increased vulnerability of member countries of a monetary union. (In De Grauwe 2011 these implications are developed in greater detail; see also Wolf 2011). One of these is that member countries of a monetary union lose much of their capacity to apply counter-cyclical budgetary policies. When, during a recession, the budget deficits increase, the risk grows of creating a loss of investors' confidence in the capacity of the sovereign to service the debt. This has the effect of raising the interest rate, making the recession worse, and leading to even higher budget deficits. As a result, countries in a monetary union can be forced into a bad equilibrium, characterized by deflation, high interest rates, high budget deficits and a banking crisis (see De Grauwe 2011 for a more formal analysis).

What kind of governance?

The previous discussion points towards the existence of a coordination failure in the euro zone. Financial markets can drive member countries into a bad equilibrium that is the result of a self-fulfilling mechanism. This coordination failure can in principle be solved by collective action aimed at steering countries towards a good equilibrium.

In addition to this coordination failure, there is another important feature of the euro zone that requires collective action. This is that the euro zone creates externalities (mainly through contagion). When one country is pushed into a bad equilibrium, this affects all the other countries mainly because of the intense degree of financial integration. As a result, a default risk in one country can lead to a default risk of sovereigns and banks in other countries. As with all externalities, government action must aim at internalizing these.

Collective action and internalization can be taken at two levels. One is at the level of the central banks; the other at the level of the government budgets.

Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because the central bank can be forced to provide all the necessary liquidity to the sovereign. This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns' debt. In fact this is what happened in the euro zone during the debt crisis. The ECB bought government bonds of distressed member countries, either directly, or indirectly by the fact that it accepted these bonds as collateral in its support of the banks from the same distressed countries. In doing so, the ECB rechanneled liquidity to countries hit by a liquidity crisis, and prevented the centrifugal forces created by financial markets from breaking up the euro zone . It was the right policy for a central bank whose "raison d'être" it is to preserve the monetary union. Yet, the ECB has been severely criticized for saving the euro zone this way. The main reason for this criticism is that these liquidity provisions have potential fiscal policy consequences. For example, when, in order to rechannel liquidity to Greece and Portugal, the ECB buys Greek and Portuguese government bonds, it exposes itself to the risk of future losses. In doing so it commits euro zone taxpayers to paying the bill in the future, without asking their permission. This criticism has been powerful enough to

convince the ECB that it should not be involved in such liquidity operations, and that instead the liquidity support must be carried out by other institutions, in particular a European Monetary Fund. I return to this issue in the next section.

Collective action and internalization can also be taken at the budgetary level. Ideally, a budgetary union is the instrument of collective action and internalization. By consolidating (centralizing) national government budgets into one central budget a mechanism of automatic transfers can be organized. Such a mechanism works as an insurance transferring resources to the country hit by a negative economic shock. In addition, such a consolidation creates a common fiscal authority that can issue debt in a currency under the control of that authority. In so doing, it protects the member states from being forced into default by financial markets. It also protects the monetary union from the centrifugal forces that financial markets can exert on the union.

This solution of the systemic problem of the euro zone requires a greater degree of political union. Economists have stressed that such a political union will be necessary to sustain the monetary union in the long run (European Commission 1977 and De Grauwe 1992). It is clear, however, that there is no willingness in Europe today to significantly increase the degree of political union. This unwillingness to move towards a stronger political union will continue to make the euro zone a fragile construction. I will not pursue this further here, but instead concentrate on the European Monetary Fund.

A European Monetary Fund

An important step was taken in May 2010 when the European Financial Stability Facility (EFSF) was instituted. This facility will be transformed into a permanent fund, the European Stabilization Mechanism (ESM), which will obtain funding from the participating countries and will provide loans to countries in need of liquidity assistance. This mechanism will make explicit the fiscal commitments of every country. Thus, a European Monetary Fund will be created, as was first proposed by Gros and Mayer (2010).

Although an important step forwards, the EFSF (and the future ESM) suffer from several problems that undermine its effectiveness.

First, the EFSF (and the future ESM) are not autonomous institutions in the way the IMF is. Each country keeps its veto power for every new financial assistance program. This feature will make these institutions very ineffective, as has already been shown. With each demand for financial assistance political bickering is set in. There will always be a politician in some country (a true Finn? Or a Dutch extreme right populist?) who dislikes the idea of providing financial assistance and will force its government to oppose a deal or to add conditions. As a result, the credibility of the institution will be undermined, as no one knows whether and under what conditions the EFSF (ESM) will be willing to provide credit. The only way to solve this problem is to transform the EFSF (ESM) into a true Monetary Fund in which decisions are taken by a qualified majority, as is the case in other European institutions (e.g., the Council of Ministers). This, of course, implies that there be a willingness to transfer sovereignty to the Monetary Fund.

Second, the tendency of the EFSF has been to impose too much austerity. There can be no doubt that financial assistance can only be given provided it is embedded in a program fiscal consolidation. Thus conditionality is essential in financial assistance, very much as this is the case in the framework of the financial assistance provided by the International Monetary Fund. The problem up to now is that the EFSF has imposed to overly harsh austerity programs. This manifests itself in different ways.

Countries that apply for financing from the ESM are countries that experience a recession or a negative shock of another type. They will be subjected to a tough budgetary austerity program as a condition for obtaining finance. Thus, with each recession, when a number of euro zone countries may be forced to turn to the ESM they will be obliged to follow pro-cyclical budgetary policies, i.e., to reduce spending and increase taxes. A sure way to make the recession worse, which in turn will make it very difficult to reduce budget deficits and debt levels.

The anti-cyclicality of government budgets is an important achievement in the developed world. It has led to greater business cycle stability and to greater social welfare, shielding people from the harshness of booms and busts in capitalist systems. The way the ESM has been set up, however, risks undermining this achievement.

It is essential that the ESM take a more intelligent approach to lending to distressed countries than the EFSF has been doing up to now. The interest rate applied by the EFSF in the Irish rescue program amounts to almost 6 percent. This high interest rate has a very unfortunate effect. First, by charging this high interest rate it is more difficult for the Irish government to reduce its budget deficit and to slow down debt accumulation. Second, by charging a risk premium of about 3 percent above the risk free rate that the German, Dutch and Austrian governments enjoy, the EFSF signals to the market that there is a significant risk of default, and thus that the Irish government may not succeed in putting its budgetary house in order. No wonder that financial markets maintain their distrust and also charge a high-risk premium. All this, in a self-fulfilling way, increases the risk of default. It has to be added that at the European Council meeting of 21 July 2011 it was decided to lower the interest rate charged by the EFSF.

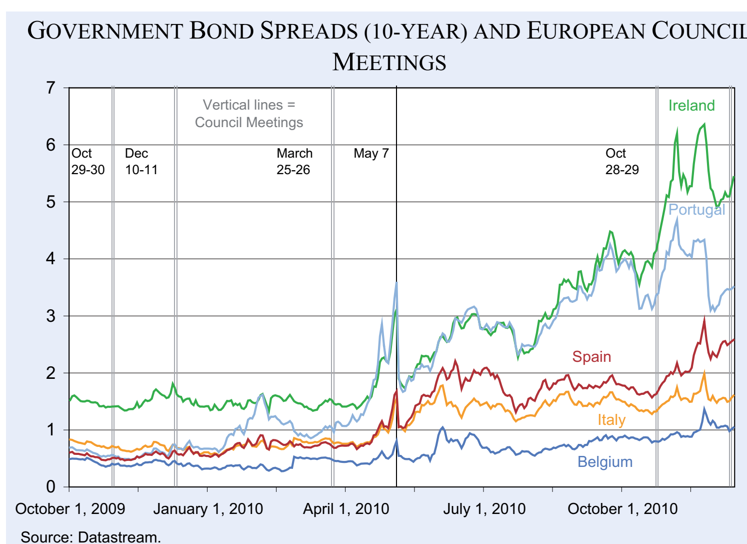
The intelligent approach to financial assistance consists in using a carrot-and-stick policy. The stick is the conditionality, i.e., an austerity package spelled out over a sufficiently long period of time, so that economic growth gets a chance. Without economic growth debt burdens cannot decline. The carrot is a concessional interest rate that makes it easier for the country concerned to stop debt accumulation. A low interest rate also expresses trust in the success of the package; trust that financial markets need in order to induce them to buy the government debt at a reasonable interest rate.

There are other features that will undermine the capacity of the future ESM to stabilize the sovereign bond markets in the euro zone . From 2013 on, all members of the euro zone will be obliged to introduce "collective actions clauses" when they issue new government bonds. The practical implication of this is the following. When in the future, a government turns to the ESM to obtain funding, private bondholders may be asked to share in the restructuring of the debt. Put differently, they may be asked to take some of the losses. This may seem to be a good decision. Bondholders will be forced to think twice when they invest in government bonds, as these bonds may not be as secure as they thought.

The intention may be good; the effect will be negative (De Grauwe 2010). In fact we have already seen the effects. When the German government made the first proposal to introduce collective action clauses at the European Council meeting of October 2010, the immediate effect was to intensify the crisis in the euro zone sovereign bond markets. I show evidence for this in Figure 3, which presents the government bond spreads of a number of euro zone countries. It can be seen that immediately after the European Council meeting of 28–29 October, when the first announcement was made to attach collective action clauses (CACs) to future government bond issues, the government bond spreads of Ireland, Portugal and Spain shot up almost immediately. Since then these spreads have remained high. This contrasts with the previous European Council meetings, which either did not seem to affect the spreads or as in the case of the May 2010 meeting was followed by a (temporary) decline in the spreads.

The reaction of the markets to the announcement of future CACs should not have been surprising. When private bondholders know that in the future their bonds will lose value when a country turns to the ESM, they will want to be compensated for the added risk with a higher interest rate. In addition, and even more importantly, each time they suspect that a country may turn to the ESM for funding they will immediately sell their bonds, so as to avoid a potential loss. But this selling activity raises the interest rate on these bonds and makes it more likely that the government will have to ask for support from the ESM.

Figure 3



Source: Datastream.

Thus the collective action clauses will make the government bond markets more fragile and more sensitive to speculative fears. I argued earlier that the systemic problem of the euro zone lies in the fact that in a monetary union the national governments are more vulnerable to liquidity crises triggered by movements in confidence in financial markets. Instead of alleviating this problem the collective action clauses will intensify it, because with each decline in confidence bondholders will "run for cover" to avoid losses, thereby triggering a crisis.

All this is quite unfortunate. Especially because the existence of a financial support mechanism in the euro zone is a great idea and a significant step forwards in the building of an integrated Europe (Peirce, Micossi and Carmassi 2011). Unfortunately, by introducing all kinds of restrictions and conditions, the ESM has been transformed into an institution that is unlikely to produce more stability in the euro zone .

Conclusion

A monetary union can only function if there is a collective mechanism of mutual support and control. Such a collective mechanism exists in a political union. In the absence of a political union, the member countries of the euro zone are condemned to fill in the necessary pieces of such a collective mechanism. The debt crisis has made it possible to fill in a few of these pieces. An example of this is the creation of the EFSF and the future ESM. These are important steps forward. What has been achieved, however, is still far from sufficient to guarantee the survival of the euro zone.

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