A New Crisis Mechanism for the Euro Area

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Introduction

When the fathers of the euro devised the common currency, they endowed it with a set of rules to buttress its credentials as a new global hard currency. According to the so-called Stability and Growth Pact, no member country was henceforth allowed to have budget deficits exceeding 3 percent of GDP, nor have public debt above 60 percent of GDP. In addition, a no-bailout clause was introduced to instil further discipline. With safeguards like that, what could possibly go wrong?

Well, if lack of enforcement makes the rules toothless and therefore less credible, quite a bit can go wrong. Until 2010, there were 97 (country/year) cases of deficits exceeding 3 percent. Fully two-thirds of such breaches were not justified by the occurrence of a significantly large domestic recession. The rules developed by the European Union to harness government debt proved to be utterly ineffective.

The global financial crisis, however, shook markets out of their complacency. And markets are less forgiving. When some euro-area countries' credit ratings began sliding down the alphabet, financial markets took notice and started to demand much higher interest premia. That put an abrupt end to careless lending and borrowing, but also brought about a serious crisis of the euro. Since then capital markets have been extremely unstable, showing signs of distrust in the creditworthiness of, in particular, the GIPS countries: Greece, Ireland, Portugal and Spain.

Under the euro the natural constraints of currency premia on excessive capital flows no longer exist. A country cannot inflate its debt away, because its bonds are denominated in a common currency whose value cannot be manipulated by national policymakers. Initially, the apparent immunity to a devaluation risk led market investors to virtually eliminate interest spreads, leading to excessive capital flows and trade imbalances. After the financial crisis, it became clear, however, that risk within the euro area was not as small as investors believed, as a rising risk of default was taking the place of depreciation risk.

Some widening of interest rate spreads relative to the excessively low levels before the crisis is to be welcomed and should be an objective of European economic policy. In a well-functioning capital market, interest spreads are the price of country-specific differences in creditworthiness. When spreads are not adequate, despite different repayment probabilities, mispricing causes countries with lower repayment probabilities to import too much capital.

The problem is that in crisis periods the self-correction mechanism through which spreads balance out excessive borrowing and lending may typically come into effect not only too late but also too sharply, with spreads swinging from too low to prohibitively high levels in a matter of weeks – as often described by the literature that stresses the danger of "sudden stops" in international capital flows. Brakes that block the wheels of a car may actually cause accidents instead of preventing them. What Europe needs is an anti-lock braking system for capital flows. This is the goal of a much-needed new economic governance system for the euro area as a whole.

What is the main deficiency of Europe's current economic constitution? To put it simply, markets found ample reasons to disregard government defaults as a real possibility. Investors knew that, at the end of the day, the euro-area countries would go out of their

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way to come up with resources to keep a troubled government afloat, disregarding the no-bailout clause of the Maastricht Treaty. A key factor systematically undermining the credibility of the no-bailout principle is the fear of contagion and systemic consequences from default. Greece was not abandoned in 2010 because, in the perception of policymakers, Europe (and as a matter of fact, the whole world) could not run the risk of "another Lehman".

Fears of contagion underlie the too-big-to-fail doctrine: banks and countries are saved because their default may result in a liquidity and credit crisis that could strangle the real economy at a national and international level. Protected by the implicit insurance, then, financial intermediaries take on too much risk, governments issue too much explicit and implicit debt, with the result of raising the likelihood of a crisis and therefore of generalised bailouts.

These bailouts foster moral hazard effects. The governments of over-indebted countries continue borrowing and creditors continue providing cheap loans recklessly. The interest spreads that would normally limit the incentive to borrow if investors feared a default risk are artificially reduced and hence there are excessive international capital flows, perpetuating the trade imbalances that led to the current crisis.

For Europe, there is no alternative but to create rules and institutions that induce market discipline. Credibility of the no-bailout clause is the essential prerequisite. Europe cannot afford to abandon market discipline vis-à-vis debtors; this is the cornerstone of its common currency and common market. But this requires setting up rules and institutions that address the fundamental issue of containing the fears and thus the risk of contagion via the banking system.

A plausible system could stand on two pillars. One is an EU-controlled public surveillance and supervision process for public debt and the banking system. The other is a credible crisis mechanism that strengthens market discipline by reducing the implicit bailout guarantee that characterised the previous situation under the euro while protecting the markets against speculative attacks and panic.

Political debt constraints

The Maastricht Treaty and the Stability and Growth Pact centred around the idea that there would be no bailout and that surveillance and numerical rules could be enforced with pecuniary sanctions to prevent fiscal crises altogether. This approach failed entirely. Despite or because of this frustrating outcome, the euro area has to try again, and now harder than before, to overcome the deficiencies. A new Stability and Growth Pact should provide tougher and more rigorous government debt constraints, and in our judgement the proposals of the Van Rompuy Commission are worth pursuing. Some of the measures advocated by the Van Rompuy Commission had indeed already been proposed by the EEAG in an earlier report (EEAG 2003, chapter 2). Our suggestions for a revised Pact still hold:

- The deficit limit should be modified in accordance with each country's debt-to-GDP ratio, in order to demand more debt discipline early enough from the highly indebted countries. As an example, the limit could be tightened by one percentage point for every ten percentage points that the debt-to-GDP ratio exceeds the 60 percent limit. A country with an 80 percent debt-to-GDP ratio, for instance, would be allowed a maximum deficit of 1 percent of GDP, while a country with a 110 percent debt-to-GDP ratio would be required to have a budget surplus of at least 2 percent.
- Sanctions for exceeding the debt limits must apply automatically, without any further political decisions, once Eurostat has formally ascertained the deficits. The sanctions can be of a pecuniary nature and take the form of covered bonds collateralised with privatisable state assets, and they can also contain non-pecuniary elements such as the withdrawal of voting rights.
- In order to ascertain deficit and debt-to-GDP ratios, Eurostat must be given the right to request information directly from every level of the national statistics offices and to conduct independent controls on site of the data gathering procedures. Eurostat should also be held responsible for failure to control.
- In case all the above assistance and control systems fail and insolvency looms, the country in question may be asked to leave the euro area by a majority of the euro-area members.
- A voluntary exit from the euro area must be possible at any time.

A credible crisis mechanism

While we endorse the attempt to rewrite the Stability and Growth Pact, we are much more confident about the discipline that markets would impose on debtor countries. It is true that markets overreacted in this crisis. But unlike the political debt constraints, the market constraints were eventually put in place, limiting abruptly a non-sustainable course. No political mechanism would have been able to force Greece, for example, to carry out the present austerity measures in a way similar to what has now been enforced by market reactions, even though these reactions were mitigated by political influence.

The challenge to the euro area consists of defining a crisis mechanism in which a credible rescue strategy stringently binds private investors (they need to have to bear some responsibility in case of losses) while at the same time preventing a panic-like aggravation of market turbulences. In addition, this mechanism should contribute to the stabilisation of the banking system in order to avoid a spiral of actual or alleged emergencies, raising the need, or the temptation, for further rescue actions.

A credible crisis mechanism must meet a number of prerequisites:

- It should not mutate into a transfer mechanism.
- It should foster efficient risk pricing by markets, ensuring that adequate interest spreads prevent further distortions in international capital flows.
- It should enable a country in need of help to continue fulfilling its governmental responsibilities and to initiate a reform programme that will return it onto an economically sustainable path.
- It should predetermine and limit investors' maximum losses.

Based on these prerequisites and on the EU countries' decisions of December 2010, in particular, the establishment of a European Stability Mechanism (ESM), we propose a three-stage crisis mechanism:

Stage 1: liquidity crisis

If a country cannot service its debt, a mere liquidity crisis will be assumed, i.e., a temporary difficulty due to a surge of scepticism in markets that will soon be overcome. The ESM will provide loans of a limited size and for a limited time to countries whose debt-to-GDP level is not yet excessive. These short-term loans, senior to private debt, could, for instance, be for a maximum of two years in succession, a time span long enough for the country to raise its taxes or cut its expenditures so as to convince private creditors to resume lending.

Stage 2: impending insolvency

If the loans are insufficient, the time has expired and the country continues to be unable to service its debt or the existing debt is already large, an impending insolvency can be assumed. Collective Action Clauses (CACs), which must form part of all government bond contracts, will ensure that a country can choose a piecemeal approach when trying to find an agreement with its creditors, dealing with one maturity of bonds at a time without holders of other maturities having the right to also put their claims on the table. The negotiating country then would offer the creditors whose claims become due so-called replacement bonds, guaranteed by the ESM up to 80 percent, only under the condition that they accept a haircut, sized on the basis of the discounts already priced in by investors during the previous three months, but of at least 20 percent and at most 50 percent. This provision is aimed at preventing turbulence in financial markets. Since the relevant average for calculating the haircut covers three months, the discount naturally charged by markets at any point in time in anticipation of losses during a possible crisis will be self-stabilising within the limits. This should help prevent panic-driven losses of market values shortly before the expected restructuring or during the negotiations about restructuring. The haircut will see to it that the banks and other owners of government bonds bear part of the risk of their investments.

The term "impending insolvency" denotes a state of acute payment difficulty, which may be overcome, however, after a limited waiver of claims and with the help of partially guaranteed replacement bonds. This is to be distinguished from actual insolvency that has far-reaching consequences for the independence of the state and puts the entire government debt outstanding, no matter its maturity, at the creditor's disposal. And it is not the same as a mere liquidity crisis, which does not pose the question of debt sustainability.

Stage 3: insolvency

Should the country be unable to service the replacement bonds and need to draw on the guarantees from the ESM, full insolvency must be declared for the entire outstanding government debt. A collective debt moratorium covering all outstanding government bonds would have to be sought between the insolvent country and its creditors.

The threat of insolvency before universal introduction of CAC bonds

The mechanism is based on the idea that all new bonds in the market issued by all euro area countries include CACs of the described type, i.e., with the possibility of a piecemeal solution to impending insolvency problems. On the one hand, the CAC bonds make the risk of a haircut, in case of threatening insolvency, explicit and structured (de facto, all bonds bear the risk of a cut, although unorganised). On the other hand, in case of impending insolvency, these bonds have the advantage of being exchangeable for replacement bonds, guaranteed to a considerable extent (our proposal: 80 percent) by the ESM.

The crisis mechanism described above applies to bonds that have a CAC. In the transition period before the new system becomes fully effective, bonds with and without CAC will coexist in variable amounts. The question arises therefore of how to deal with an impending insolvency involving bonds without CAC.

As long as the presently valid rescue packages (Greece and EFSF) are in force, the problem will not arise. But a serious payment crisis may occur in an interim phase, during which these rescue packages no longer work and the conversion of the old government debt into CAC securities has not been completed.

In principle, one could proceed in the way described above. The owners of newly issued CACs will stick to their contract (for instance, they will not be able to exercise their claims before bond maturity). However, nothing prevents owners of standard bonds without CACs from exercising their claim prematurely. Since, in addition, unanimity must be reached, negotiations will in principle be complicated.

Nonetheless, the plan provides a workable framework for negotiations between the affected creditors and the ESM. Creditors ought to be offered somewhat better terms, in order to reach agreement. It is conceivable that, after a haircut on the order of the market discount and the above-mentioned limits (at least 20 percent, at most 50 percent), the full remaining value of the old bonds could be exchanged into replacement bonds that are fully, rather than only partially guaranteed, by the ESM. And of course the general rule that the sum of all guarantees must not exceed 30 percent of GDP needs to be respected. It is essential that the principle that the haircut precedes the aid should not be given up even in this improbable special case, as the aid will have stabilisation effects compared to what is laid down in the rules of the Maastricht Treaty. Those who do not accept the thus-specified aid offer may try to recover their claims in court, but receive no guarantees whatsoever from the ESM.

Stabilisation effects

After all old bonds have expired or have been exchanged into CAC bonds, the crisis mechanism is fully operative. It will instil more debt discipline and will help stabilise the markets. The risk of domino effects, like those evoked in May 2010 in order to justify the discretionary rescue programmes amounting to billions of euros, will be effectively minimised. Our optimism rests on the following considerations:

- A strengthening of the Stability and Growth Pact, along the lines proposed by the Van Rompuy Commission and largely accepted by the representatives of the member states, ought to induce at least some countries to reduce their budget deficits and outstanding debt.
- The announcement of the crisis mechanism will induce investors to continue to demand interest spreads when buying new government bonds and to reduce credit granted to less solid countries. Higher interest rates will discourage deficit spending and lead to sounder government finances. This market-driven mechanism will have a stronger effect than all political debt limits.
- The protective shields, agreed in Washington and Paris on 11 and 12 October 2008 after the Lehman bankruptcy and amounting to 4,900 billion euros, will remain intact. That alone makes a breakdown of the interbank market like the one that occurred after the Lehman bankruptcy on 15 September 2008 extremely improbable if not impossible.
- The fact that a crisis mechanism exists, which in addition limits the maximum losses, helps banks and other investors in planning for a country's payment crisis. This should limit any possible turbulence in the financial markets. Since, in the second stage of the crisis mechanism, a haircut is stipulated, which conforms to the average market discount during the last three months preceding the announcement of restructuring measures, the risk of market turbulence is limited. Whenever the prices threaten to diverge from the moving average of the last three months, profitable and stabilising speculation becomes possible that will

push the prices back to this average. In addition, strategic purchases or sales will hardly be able to affect the maximum haircut during the negotiation period.

- A divergence of interest rates does not necessarily mean that banks are losing capital, as in the normal case the interest rates of states with a good credit standing will be pushed down and their bond prices will be pushed up. This was also the case in the current crisis.

Related to the last point, we would like to emphasise that the haircut is not in itself a destabilising element of a crisis mechanism, as is sometimes claimed by interested parties. According to our proposed rule, the haircut is engineered so as to exert a stabilising effect, as its size reflects – within the limits set – the discount on the issue price already realised in the market. The discounts on long-term Greek securities amounted to about 30 percent in early November 2010 and also in May 2010. If a haircut of the proposed dimensions had been applied then, no market turbulence would have been triggered, because the expectations of the market agents would have materialised. In contrast, a continuation and expansion of the comprehensive insurance rescue, which was agreed in May 2010, would have resulted in a sudden increase of prices, speculation profits and a considerable destabilisation of markets. Not only downward swings are destabilising. Upward swings are destabilising, too, because they may create opportunities for opportunistic speculation.

References

EEAG (2003), *Report on the European Economy 2003*, CESifo, Munich.

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