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A call for a European Financial Stability Fund

CEPS Commentary/30 October 2008

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Why is the euro plunging against the dollar and the yen? Why are European banks coming under renewed pressure? Should the emerging financial and foreign exchange crisis of countries gravitating around the euro lead to new EU policy instrument?

The euro is plunging against the dollar because investors, in their scramble for safety and liquidity, are flocking to US and, also to some extent, Japanese government bonds which are considered safer and more liquid than other government-backed paper available in the market – including public debt instruments issued by European governments. In other words, the constellation of separate markets for sovereign debt paper of unequal quality issued by European governments cannot compete, with the US market for the huge global financial flows in search of a safe harbour. Until the EU develops a unified market for bonds denominated in euro and backed jointly by EU member states – or, better, by euro-area member states – its claim for the status of reserve currency for the euro will not be met. As a result, capital is not coming to Europe, where it is badly needed to shore up its shaken financial system; moreover, the United States will continue to dictate the agenda in international monetary affairs, even now, after the colossal damage inflicted on the world by their misguided macro and regulatory policies. To add insult to injury the US government is now paying 2-3 percentage points less on its short term debt than even the most virtuous EU member states.

Second, why are European banks coming under renewed pressure, and how is this related to mounting pressures in countries gravitating around the euro? Worsening economic prospects are only part of the explanation. The deteriorating foreign exchange and financial conditions of satellite countries in the euro area – from the Baltic region, to Eastern Europe, Turkey and Ukraine, not to mention the imploded Icelandic financial system – is also weighing heavily on EU banks' financial solidity since they provide the backbone of the banking and financial system in those countries, and therefore are now much exposed to the consequences of mounting capital flights and currency attacks in those countries. European banks hold over $1,500 billion of cross-border claims on emerging European economies (out of a total of $1,620 billion). When all European banks run for the exit, they are increasing their own losses – thus fuelling the need for further recapitalisation.

There is no escape: the European Union will have to take responsibility for the stabilisation of financial conditions in these euro-satellites and will need substantial resources to be able to do it – for emergency balance of payment assistance as well as direct provision of good government paper in exchange for flawed private claims, precisely as the United States did with their Brady Bonds in the 1980s to resolve the Latin American debt crisis. The existing funds for Macro Financial Assistance that could be mobilised are much too small to have a substantial impact.

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A shortened version of this commentary was published in the Financial Times.

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European banks are also coming under renewed pressure because the national rescue programmes put in place following the meeting of the Heads of State and Government of the euro area on October 12th are starting to look insufficient. One reason is their prevalent case-by-case approach, which has kept banks away from their governments' helping hand for fear of political interference in the choice of management or credit policies. This applies in particular to Italy and Germany, where the largest private banks have so far declined to apply for government capital infusions and guarantees because they fear heavy handed intervention by their national finance ministries. Another reason is that country-based rescue plans fail to provide convincing guarantees to depositors and investors in large cross-border banks where it is far from clear who will take responsibility for losses generated in an EU country other than that of legal residence. The near run on the branches of ING in Spain illustrates how deep this mistrust runs.

The way ahead has already been shown by the US and UK authorities with their de facto compulsory recapitalisation of all main banks – which was followed by a similar approach in France. The case-by-case approach must be abandoned and an ambitious capital target must be set for all EU main banks. Again, there is no need to tap national budgets in order to do so. EU government-backed bonds can provide adequate resources by making it possible to tap the gigantic global capital flows in search of safety; the euro and the credibility of the European financial markets would greatly benefit from these capital inflows.

The overall message from financial markets is that investors everywhere have developed a strong preference for public debt. In the US and Japan, public debt carries no risk because if needed the government could always force the (national) central bank to print the money needed to meet its obligations. But this is not the case in Europe since no European government can force the ECB to print money. For international investors there is thus no euro area government bond in which they could invest to diversify their risk away from the dollar.

We thus have at one and the same time strong demand for 'European' bonds and a need for massive government capital infusions to prevent the crisis from getting worse in the banking sector and the European periphery. This is why the EU should set up a massive European Financial Stability Fund (EFSF). The fund will probably have to be at least on the scale of the US Troubled Assets Relief Programme (TARP), say €500–700 billion. It would issue bonds on the international market with the explicit guarantee of member states. As the rationale for the EFSF is crisis management, its operations should be wound down after a pre-determined period (5 years?). For global investors EFSF bonds would be practically riskless having the backing of all member states.

Setting up a fund with a common guarantee does not imply that stronger member countries would have to pay for the mistakes of the others since at the end of its operations losses could be distributed across member countries according to where they arose. But in all likelihood the Fund would not lose, but rather would make money, because its funding costs would be much lower than that of member states and because its existence would stabilize European financial markets. Germany, which so far has opposed this idea might be the biggest beneficiary because German banks are likely to be its biggest customer, Germany's automobile industry would gain most from a stabilization of the European banking sector and Germany's exporters would gain most from a stabilization of the European perifery.

This Fund could be set up quickly at the European Investment Bank, which already exists as a solid institution with the necessary expertise. (Technically the EIB is an agency of EU governments whose board of governors includes the ministers of finance of member countries). A fund run be a European institution would lead to a different political economy dynamic since national finance ministers will have an interest to see it wound down once financial markets operate again normally. By contrast, it will be much more difficult to end national support schemes since no finance minister will want to be the first one to withdraw support for his or her national champions.

The resources available to the EFSF would be used mainly for bank recapitalization, especially for those banks which rather 'gamble for resurrection' than accept the presence of heavy handed interference of national governments. Moreover, the EFSF could also beef up the funding of existing EU instruments for balance of payments assistance to the European neighborhood. But a key consideration in setting up such an emergency fund should not be the problems that are already known. Given the unpredictable nature of this crisis a key consideration should be for the EU to prepare for the 'unknown unknowns' that are certain to arrive sooner rather than later.

President Sarkozy has recently called for the creation of an economic government for the euro area. Under normal circumstances one would have replied that the economic governance of the euro area was assured by the independence of the ECB and the Stability Pact. This is clearly no longer sufficient when Europe is facing the worst economic and financial crisis since World War II. The speed and depth of the crisis have clearly overwhelmed the usual decision making mechanisms. Europe needs action on a scale that can only be decided at the highest political level.