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Financial Stability beyond Greece: On the need for a European Financial Stability Fund

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In his seminal work on international financial crises, Larry Summers wrote that policy-makers facing a crisis tend to go through a process reminiscent of the five stages of grief. The process starts with denial that a crisis could be taking place. This is followed by anger, with a tendency to assign blame (speculators, rating agencies, etc.). Third, there is the bargaining (with the markets, seen as potential saviors). Fourth comes despair, leading eventually to the decision to call for help (IMF, EU). It is finally only in the fifth stage – acceptance – that the way is opened to a credible plan.

The European Council seems to be stuck between the first two stages. At first its position was that no crisis could arise because it (the European Council) was ready to intervene. Now it insists that Greece has a credible programme in place and blames any contagion on unjustified speculation.

Our own evaluation of the fundamentals in Spain indeed is that the country does not face an intractable insolvency problem, but this is irrelevant in a crisis, when markets do not give policy-makers the time to go through the stages described above. With contagion spreading and even Italy no longer totally immune, the cost of further delay might be a full-blown financial crisis with incalculable costs.

The starting point for credible action must be recognition of the nature and scale of the problem we are facing. The key point is simply that a banking crisis tends to become a sovereign debt crisis and vice versa. This poses a particular challenge for the euro area which has an integrated banking market, but where sovereign debt remains national.

A liquidity crisis is in principle a problem for monetary policy and would call for a massive intervention by the European Central Bank. However, the lender of last resort function always falls in the grey zone between monetary and fiscal policy, particularly in a systemic crisis when the border between solvency and liquidity problems is blurred. In the US, this does not matter as the Fed and the Treasury stand shoulder-to-shoulder, each one providing a guarantee for the other. This is different in the euro area where the ECB cannot just act as the agent of the fiscal authorities. Using the ECB in a large-scale operation to shore up public finances in some member countries would constitute a frontal attack on a key principle of the Maastricht Treaty.

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Moreover, we need to keep in mind that it is true that a liquidity problem postponed is a problem solved but a solvency problem postponed is a problem made intractable. Using the ECB to prop up troubled countries will only magnify the problem over time.

So what can be done at this point?

The experience of the US at the peak of the crisis in early 2009 has shown that a combination of stress tests coupled with forceful intervention can quickly reduce the perception of counter party risk, which is lethal for financial markets. All EU supervisory authorities should thus conduct tough stress tests of their banks. In the creditor (Northern) member countries the tests should focus on the exposure to Southern euro area member countries. Specifically, they should assess the adequacy of capital and reserves to cover losses arising in adverse scenarios in terms of growth and risk premia which will impact the ability of both sovereign and private sector debtors to service their debt. If the stress tests reveal that some institutions could not survive a default in any of the problematic countries, they should be forced to accept a recapitalization and transfer their claims at a discount to the government, or to the bad banks, where they exist. In this way further problems could be 'ring-fenced'; governments will no longer be condemned to throw good money after bad should the adjustment programs in Greece (and Portugal or Spain?) not work.

Table 1 below shows that all forms of credit to government amount to about 130% of capital and reserves. This illustrates the old rule that a sovereign default and a banking crisis represent two sides of the same coin: an excess level of debt in the system. Fortunately, however, the public debt of the three countries most at risk (Greece, Portugal and Spain) amounts to only about 14% of all public debt in the euro area. The overall exposure of euro area banks to the public sector in the three countries under speculative attack is thus large in absolute terms (about €400 billion) but even a 50% loss should be manageable, amounting to about 10% of aggregate capital and reserves of the banks in the euro area.

Table 1 Exposure of euro area banks to government as % of capital and reserves

	Loans	Securities	Total
Central government	12	64	76
General government	52	77	129

The second key point is to give markets a clear signal that Europe would be able to deal with a sovereign risk crisis in a structured way. We have argued previously for the creation of a European Fund to be financed by contributions from the countries representing the greatest risks, i.e. those with the highest deficits and debts. Such a fund is now urgently needed. While there is not time to build up its capital in the manner we originally suggested, a starting capital is already available: Euro area member countries have already pledged €80 billion in credits for Greece alone. These funds could be simply channelled towards a common institution, a European Financial Stability Fund (EFSF), which would not only manage the euro area's contribution to the Greek package (and Portugal, if necessary), this institution could also organise a smooth insolvency of a member state should an austerity programme fail.

The few months needed to build up the EFSF could be bridged by the €30 billion contribution from the IMF, which could be used to finance Greece until it is clearer whether the austerity plan has any chance of working.

Should the EFSF need more funding, it would have to issue 'euro bonds', i.e. bonds guaranteed pro rata by euro area governments, which would give the EFSF the necessary fire power to deal with cases like Spain. The mere existence of such an authority to borrow would be a key source of reassurance to calm markets, as investors would know that it would not take months to deal with problems.

The passage on the stages of grief is adapted from Lawrence H. Summers, "International Financial Crises: Causes, Prevention, and Cures", *The American Economic Review*, Vol. 90, No. 2, Papers and Proceedings, May, 2000, pp. 1-16.