Financial Stability beyond Greece:
Making the most of the European Stabilisation Mechanism

Daniel Gros and Thomas Mayer

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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.

As the crisis escalated up to its climax in early May, the European Council seems to have been 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. Then it insisted that Greece had a credible programme in place and blamed the spread of the contagion to Portugal and Spain on immoral 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. When contagion was spreading and even Italy no longer totally immune, it became finally clear that the cost of further delay would be a full-blown financial crisis with incalculable costs.

At this point the European Council finally recognised the problem and put together an impressive rescue package with potentially €600 billion in loans available for countries with potential funding problems, to be channelled through a newly created European Stabilisation Mechanism.

However, the EU authorities seem to have only partially recognised the nature and scale of the problem the eurozone has to face. 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 and should not act simply as the agent of the (national) fiscal authorities. In the context of the EU’s rescue package, the ECB decided to buy directly bonds in those markets it considers ‘dysfunctional’. This is a
dangerous and slippery slope. There might be grounds for limited interventions when markets break down, in
the sense that bid/ask spreads are so wide that trading stops, but a large-scale operation to shore up public
finances in selected member countries constitutes a frontal attack on a key principle of the Maastricht Treaty.

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 counterparty 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.

The table below shows that all forms of credit by euro area banks to governments 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>
<thead>
<tr>
<th>Loans</th>
<th>Securities</th>
<th>Total</th>
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<tbody>
<tr>
<td>Central governments</td>
<td>12</td>
<td>64</td>
</tr>
<tr>
<td>General government</td>
<td>52</td>
<td>77</td>
</tr>
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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. The EU cannot continue to invent rescue packages over week ends under the
pressure of an impending meltdown of the financial system.

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 hundreds of billions of
euros for Greece and other countries under the European Stabilisation Mechanism. This ‘Mechanism’ is for
the time being only a ‘special purpose vehicle’, but it should be developed into a new institution, which
would not only manage the euro area’s contribution to various rescue packages and supervise their
conditionality. This institution should also be a key element of the still to be defined framework of fiscal
policy for the euro area. Last, but not least, this institution, with its considerable financial backing, could also
be used to organise a smooth insolvency of a member state should an austerity programme fail.

This last point is key for the credibility of the framework for fiscal policy that should now be drawn up as
quickly as possible. As long as no member country is allowed to go insolvent because financial markets
cannot absorb the losses, the euro area can survive only if all member countries behave in a cooperative and
responsible manner. Experience has shown that this cannot be taken for granted.

The passage on the stages of grief is adapted from Lawrence H. Summers, “International Financial Crises: Causes,