



Euro crisis: institutional tug-of-war

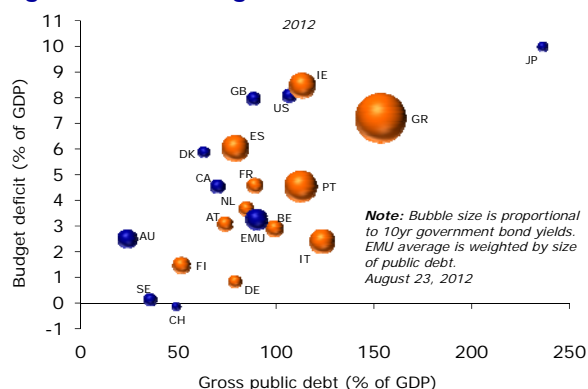
Despite the steps taken by European policymakers to improve the institutional framework of the eurozone, the monetary union still has no credible crisis mechanism. We argue that the current ECB proposal can at best only restore calm to the markets temporarily. For this reason, the muddle-through scenario would seem to be the most realistic probability for the time being.

Why is there a debt crisis in the EMU?

Eurozone policymakers often wonder why the average interest rate in the European Economic and Monetary Union (EMU) is higher than most advanced countries while the region's public finances are relatively healthier than some of its peers (e.g. Japan, the UK and the US). Figure 1 shows that the average budget deficit and public debt of the EMU compares favourably from an international perspective. What's more, the EMU's current account (CA) is more or less balanced, meaning that the region does not suffer from any significant savings deficit. The same cannot be said for the UK and the US, which run sizable CA deficits¹ and are, therefore, reliant on foreign investors for their financing needs.

So basic fiscal metrics offer no clear reason why market participants attach a higher default risk to the EMU than, say, the US even though the latter seems to have a weaker fiscal position. Economists have provided a number of reasons why investors treat the EMU differently; these include larger internal disparities within the region, absence of automatic fiscal transfers or cross-guarantees, greater rigidity in product and labour markets as well as lower labour mobility. While all these factors may push up sovereign risk, we believe the single biggest factor behind higher default

Figure 1: Assessing fiscal vulnerabilities



Source: IMF, Reuters EcoWin, Rabobank

risk in the eurozone is that it does not possess a credible crisis mechanism. To appreciate this, consider that eurozone members issue debt in a currency over which they no longer have control. As such, the financial markets have the power to force default on each member if investors rush for the exit. In other words, a liquidity crisis quickly turns into a solvency crisis. But this does not hold for a country that is an issuer of a sovereign currency (i.e. a government that borrows using its own floating currency) and has almost no foreign-currency denominated debt (mostly the case in the industrialised world). In the latter case, if investors shun the sovereign's debt, their central banks typically step in with quantitative easing measures to ensure financial stability, hence preventing the liquidity issue morphing into a solvency issue.

Thus, as long as Europe does not install a credible and automatically activating crisis mechanism and the ECB remains reluctant to pursue open-ended quantitative easing to bring down interest rates across the curve, which has been the case until now, EMU countries can fall prey to market pressures.

Europe reinforces its foundations

Since the crisis began, European politicians have taken various steps to improve the

¹ The average CA deficit of the UK and the US during 1995-2011 was 1.8% and 3.1%, respectively.

eurozone's institutional framework. We distinguish three policy areas: public finances, economic policy and the formation of a banking union. To put *public finances* on a sounder footing, the Stability and Growth Pact (SGP) has been tightened up. Finance Ministers can now only avoid 'semi-automatic' penalties for breaching the budgetary rules on the basis of a qualified majority. In addition, 25 EU member states have signed the 'Fiscal Compact', in which it is agreed that striving to achieve a balanced budget will be enshrined in national legislation². Besides budgetary policy, various initiatives have been developed in order to enable influence to be brought to bear on the *economic policy* of individual member states. This is crucial given the fact that, with hindsight, macroeconomic imbalances have also clearly contributed to unsustainable public finances. Lastly, steps have recently been taken towards the formation of a European *banking union*. This is necessary in order to break the vicious circle between governments and banks. The common thread in the measures that have been taken is that compliance with the existing agreements will be improved and that the member states can exercise more influence on each other's policy, either through the European Commission or otherwise.

These steps will improve the eurozone's institutional framework in the long term, although each of them raise one or more unanswered questions and/or have limitations as to their effectiveness. However, a credible mechanism that will operate automatically in times of crisis has still not been created. The mechanism intended to fulfil this role, the European Stability Mechanism (ESM), is, as shown by the continuing turmoil in the bond markets, seen as too limited in terms of both scale and effectiveness. An analysis of the complex interplay of forces in Europe shows clearly why this gap will only be filled in gradual steps.

² See Rabobank SR 12/13 'Fiscal compact will not prevent the future crisis' for further information.

No simple solution

Peripheral countries grapple with their task of austerity and reform. If their governments cut spending too quickly, there is a risk that the resulting economic downturn will mean that the desired improvement in public finances will not be adequately achieved. The positive effects of structural reforms on economic growth will only become visible years after the policy changes are implemented. To get public finances in order and demonstrably strengthen the economy will therefore take a long time, financial markets are not prepared to wait. The withdrawal of (foreign) private investors has led to high interest rates for governments and businesses in these countries.

In order to achieve the necessary austerity and reforms at a feasible rate and avoid defaults, the northern member states can buy the time needed by the peripheral countries that the financial markets are unwilling to provide. Just like the markets, the northern euro countries are reluctant to guarantee more loans to the southern member states (via the European Financial Stability Facility, EFSF), or to make additional contributions to the capitalisation of the permanent bailout fund (ESM). Firstly, if they are too accommodative this could remove the pressure on the southern member states to carry through the cuts and reforms. The negotiations in Europe thus revolve around European support for the weak member states in combination with transfer (to Brussels) or limitation (via constitutional or legislative changes) of national control over economic and budgetary policy. Secondly, it is difficult to explain to the electorates in northern European countries why they should undergo austerity at home while large loans and guarantees are being extended to other European countries. A certain degree of crisis is thus still necessary to convince people that such measures are needed. The bottom line from a eurocrisis perspective is that it is not in North Europe's interest to remove the atmosphere of crisis entirely in the short term.

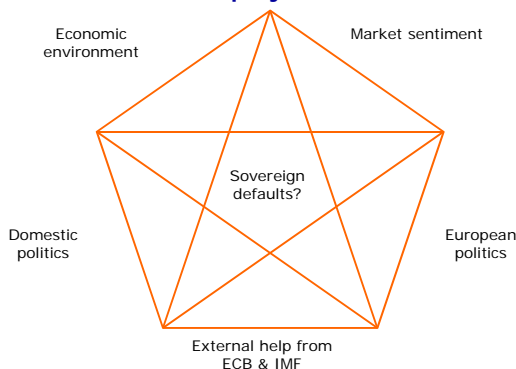
ECB stands firm

Since European politicians are only gradually managing to come up with a credible crisis mechanism, attention has meanwhile turned to the ECB. As a potential rescuer of last resort, it adds an extra dimension to the complex inter-play of forces (figure 2).

However if the ECB takes up its role as rescuer of last resort too eagerly, this will remove the incentive for Europe to provide the solution to its economic and budgetary problems that is needed, in the form of a fully ratified crisis mechanism in which the rules and procedures for support in a crisis are credibly established. Furthermore, the mandate of the independent ECB extends to price stability and financial stability, which until now has been the motivation for it not to get involved in large-scale monetary financing. Indeed, as a result of the existence of 17 bond markets in the eurozone, this would in fact entail financial support being given to individual member states. Unlike its US and UK counterparts therefore, the ECB has so far only purchased Eurozone government bonds to a relatively limited extent (figure 3).

Despite the ECB's view that it is for the politicians to provide a mature institutional framework for the eurozone, its ability to stand firm is limited. First of all, it seems that currently there is not enough political backing for a credible rescue mechanism, meaning that financial stability could be threatened. In addition, the actual implementation of

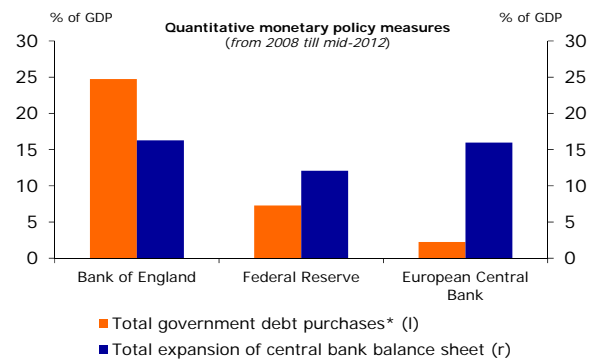
Figure 2: The web of players and interactions



Source: Rabobank

institutional reforms will be a lengthy process. The recent 'conditional commitment' by ECB President Draghi – in which he said that the ECB would be prepared to purchase more peripheral government paper if a country was in receipt of support from the EFSF or the ESM – is at best a short-term solution in our view that can restore calm to the markets only temporarily. The conditionality of the commitment implies that peripheral countries will have to continue on the path of austerity and reform if they wish to take up the ECB's offer. The ECB moreover sees its support only as a supplement to a 'political' rescue mechanism, which in turn requires further optimisation of the institutional framework.

Figure 3: Is the ECB picking up the baton?



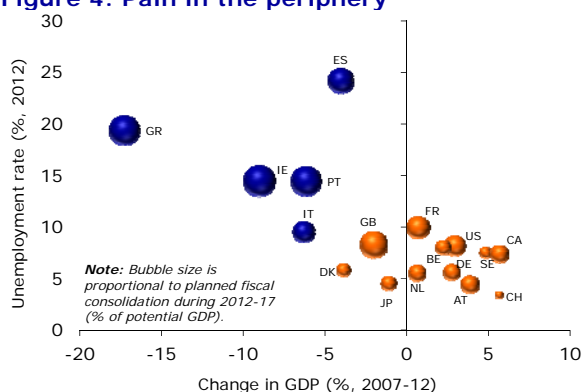
Source: Reuters EcoWin

Big Bang or muddle-through?

This political balancing act means the crisis is unlikely to end in a Big Bang whereby either the 'core' countries add trillions of euros to the bailout funds to be deployed without any strings attached or the ECB provides a blanket guarantee on all government bonds. The most likely scenario is that the two-tier tug-of-war between the ECB and the eurozone leaders, on the one hand, and between the leaders of the core and periphery countries, on the other hand, will continue in order to make sure that the reforms and austerity measures are carried out in full. The advantage of this approach is that the periphery countries will eventually come stronger out of this crisis if given enough time. The obvious risk is that the simultaneous

private and public sector deleveraging in the periphery pushes them deeper into the red, which will place an enormous strain on their social fabric given high and rising jobless rates (figure 4). Furthermore, the bouts of negative sentiment continue to stay like dark clouds over the eurozone economy and drag on growth, which is already weak amid simultaneous private and public sector deleveraging.

Figure 4: Pain in the periphery



Source: IMF, Reuters EcoWin, Rabobank

The least costly way forward

We believe that crisis resolution requires at least the following three main ingredients.

1. **Lower sovereign risk:** The EU leaders have to consider pooling fiscal risks in addition to strengthening their fiscal rules. Debt mutualisation through eurobonds would be considered a very important step. The condition for this is obviously moving towards stronger budgetary and economic policy coordination. The ECB must also stand ready to resort to more unconventional tools should the situation warrant it. This should only serve as a short-term solution since indefinite monetary financing of public debt is undesirable.
2. **Lower banking sector strains:** Given the destructive fiscal-financial nexus, the EU leaders must take serious steps to implement the agreed-upon banking union. But since this will take time to be fully implemented, it will only serve as a long-

term goal to reduce the chance of another Spanish or Irish crisis. In the short term, the bailout funds must be utilised to recapitalise banks directly. Credible stress tests must also be carried out to improve transparency. Following these measures, funding costs for all European banks will improve, which will not only result in lower sovereign risk (especially in Spain and Ireland) but also loosen credit conditions

3. **Support growth:** Growth will first and foremost be supported via crisis resolution through a rebound in depressed confidence levels. On top of that, the periphery countries must get more time to improve their fiscal imbalances and competitiveness. The core countries should also assist by supporting their domestic demand. In the meantime, the ECB must run a sufficiently accommodative monetary policy, consistent with the recognition that deflationary dynamics in the periphery, once in train, are particularly difficult to reverse.

A failure to act can lead to messy sovereign defaults or even a complete break-up of the eurozone. We can only hope that policymakers are serious about doing 'whatever it takes' to maintain the euro.

September 2012

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