

spotlight europe

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Who's next? The Eurozone in an Insolvency Trap

Robert B. Vehrkamp

Bertelsmann Stiftung, robert.vehrkamp@bertelsmann-stiftung.de

There is going to be a brand new euro, at least from 2013 onwards, and people are talking about the Grand Design of a new European Economic Governance. But after the collapse of Portugal one is led to ask whether the eurozone can actually make it to safety. And what happens when it gets there? At any rate, the danger of new crises is greater than it has ever been. The fact of the matter is that the euro is in an insolvency trap.

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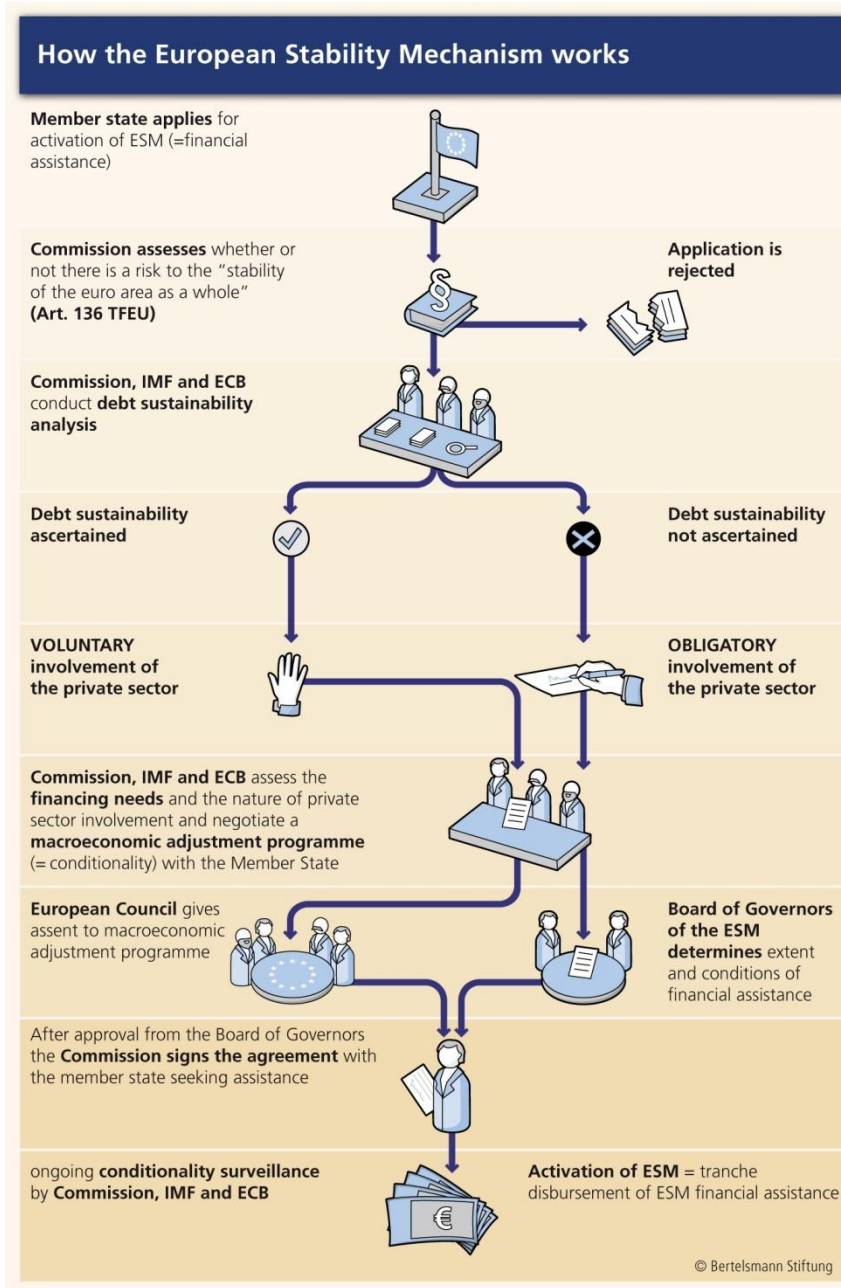
Let us start with the bad side of the good news. Whereas it is true that the new 2013 euro will be more crisis-resistant than its predecessor, it is not going to solve the pressing problems of the eurozone. Precisely the opposite is the case. It will exacerbate the financial problems of the debt sinners and make unavoidable what policymakers would in fact very much like to avoid, that is, the restructuring of the debt of the biggest debt sinners in the eurozone. Such restructuring is inherent in the logic of the resolutions adopted by the European Council on 24/25 March 2011, and of its central feature, the European Stabilization Mechanism (ESM). One does not have to feel sorry about this, but for those who still have their doubts the following tour d'horizon of the brave new euro-world may prove to be helpful.

It's the ESM, stupid!

The centrepiece of the new euro is the European Stabilization Mechanism (ESM), which from the middle of 2013 onwards is destined to replace the current provisional safety net (EFSF). Compared to this, the reformed Stability and Growth Pact III, the Euro-Plus Pact for more competitiveness, the new macroeconomic surveillance procedure, the European Semester, and the refurbished EU 2020 Strategy pale into insignificance. These are all important steps in the economic policy governance of Europe. But the fact remains that the ESM is at the heart of the new euro. What is the reason for this?

It is because the ESM is nothing less than a European Monetary Fund based and modelled on its big brother, the Interna-

nality tool in countries that, for whatever reason, are compelled to make use of ESM financial assistance. Similarly, the indirect influence of ESM conditionality will encourage states to adjust to ESM standards in order to forestall market sanctions and to avoid having to apply for ESM assistance. Such ESM adjustment pressure will resemble the asymmetrical structure of the former European Monetary System (EMS), which, especially during the 1980s, successfully prepared countries such as France and Italy, which used to have weak currencies, for the euro.



tional Monetary Fund (IMF). And just as the IMF, which is probably the most influential institution in the global economy, determines (or, if we are going to be politically correct, influences) the economic policy of many of its member states, the ESM will in future influence (or, if we are going to be politically correct, determine) the economic policy of many member states of the eurozone. This influence will be exerted either directly via the condition-

ality tool in countries that, for whatever reason, are compelled to make use of ESM financial assistance. Similarly, the indirect influence of ESM conditionality will encourage states to adjust to ESM standards in order to forestall market sanctions and to avoid having to apply for ESM assistance. Such ESM adjustment pressure will resemble the asymmetrical structure of the former European Monetary System (EMS), which, especially during the 1980s, successfully prepared countries such as France and Italy, which used to have weak currencies, for the euro.

But what is the ESM? How does it work, and what is the economic logic on which it is based? And above all, why does its introduction mean that debt restructuring in the eurozone is unavoidable now and not merely at some point in the future? Why in particular is the ESM going to catapult the eurozone into an insolvency trap? Here are some tentative answers:

It was decided to set up the ESM as a permanent mechanism for crisis prevention. It is supposed to be replacing the European Financial Stabilization Facility (EFSF), which runs out in the middle of 2013.

With its guaranteed nominal capital of €620 billion plus €80 billion cash deposit

supplied by the member states, the ESM can in future disburse loans of up to €500 billion without endangering its AAA rating in the course of the refinancing process.

The sole purpose of these loans is “to safeguard the stability of the euro area as a whole.” That at any rate is the text of the Council’s revised version of § 136 of the Treaty of Lisbon which is designed to legalize the permanent establishment of the ESM.

II

The ESM as a European Monetary Fund

The following aspects and qualities in particular need to be borne in mind in order to understand the inner workings of the ESM:

The ESM is a monetary fund. Since it is a genuine capital fund, the ESM is not designed to provide first aid on a non-profit basis, nor is it a community institution imbued with the spirit of democracy. The member states guarantee the capital of the fund to the extent specified by their capital quotas and pay in their allotted share of the cash deposit, and, in contrast to the majority of EU institutions, in the case of the EMS it is true to say that he who pays the piper calls the tune. The voting weights of the member states on the ESM governing board reflect their capital quotas. Since all ESM decisions are made either unanimously or with a qualified majority of 80 % of the voting rights, this means in so many words that Germany (27.2 %) and France (20.4 %) each have their own blocking minority against which the ESM can decide nothing whatsoever.

Over-indebtedness leads automatically to restructuring. In cases of over-indebtedness a country can obtain credit assistance from the ESM only if restructuring has ensured the appropriate participation of private creditors. To this end the Commission acting in conjunction with the

IMF and the ECB will subject every applicant to an examination in order to ascertain his debt sustainability. If this turns out to be negative, the prior participation of private creditors is a sine qua non for credit assistance from the ESM.

The ESM will provide credit assistance only with strict conditions attached. Before the ESM is activated, the applicant state will have to reach agreement with the Commission, the IMF and the ECB on a macroeconomic adjustment programme (=conditionality), which will be initiated in a Memorandum of Understanding. Such conditionality may affect all areas of economic and financial policy, and may stipulate detailed courses of action and quantified targets and goals, e.g. for the fiscal, wages, privatization and structural policies of the country concerned. Authorization of and disbursement of ESM credit assistance instalments are dependent on compliance with and the ongoing surveillance of this conditionality. The net result is that a country will be relinquishing an important part of its economic and finance policy autonomy whilst it is receiving ESM credit assistance.

The Commission will be responsible for the ESM. A striking feature of the institutional arrangements for the ESM is the central and in fact very powerful position of the Commission. It alone initially decides whether or not “the stability of the euro area as a whole” is being endangered, and whether the preconditions for ESM activation have been met. Moreover, it will conduct a debt sustainability analysis, will specify the nature and extent of the participation of private creditors, and will negotiate and sign off on the conditionality of the macroeconomic adjustment programmes. The ongoing surveillance is also in the hands of the Commission, though as in the entire procedure it will act in conjunction with the IMF and the ECB. It is true that political decisions are needed from the European Council (which has to give its assent to the MoU) and from the finance ministers of the Member States

who sit on the ESM governing board, which decides on the financial terms and conditions attached to any credit assistance. But the role of the Commission is crucial to all parts of the ESM process.

III

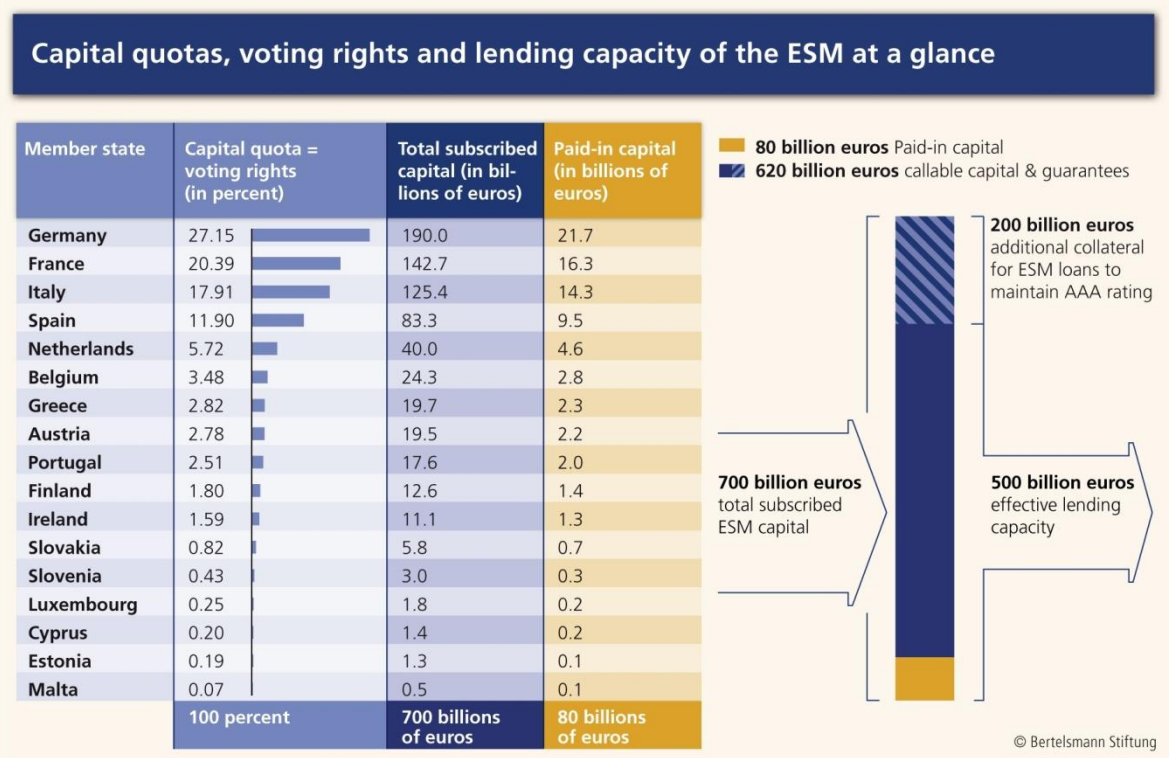
The Nucleus of a European Economic Government?

The principle of conditionality and the central role of the Commission in the ESM indicate that in future the ESM will be the most important and above all the most

powerful tool with which the EU can bring its influence to bear on national economic policies in the eurozone. Thus the ESM is in fact the nucleus of a European economic government.

the new tool of conditionality, the Open Method of Coordination of the Lisbon Process, the voluntary target agreements of the Euro-Plus Pact and even the sanctions regime of the reformed Stability and Growth Pact look rather harmless. It is abundantly clear that the Council and the Commission have never before had at their disposal a tool that is as effective as conditionality when it comes to influencing the economic and finance policies of the EU member states.

And above all the Commission will be only too happy to use this tool. It is true that ESM activation is designed for cases of



genuine financial distress, and should come into play only if all other methods of coordination and assistance have failed. However, the bottleneck specified in the new Article 136 seems to be rather elastic. As we have seen, the question of whether “the stability of the euro area as a whole” is being threatened is something for the Commission to decide. Will it be tempted to define this bottleneck rather generously when it grants credit assistance in order to acquire some kind of control over economic policy in the eurozone?

As a result of the conditionality attached to its provisional safety net the EU already determines national economic policies in Greece, Ireland and Portugal to an extent that would have been unthinkable with the other traditional tools of voluntary coordination. In retrospect, when compared to

It is not very difficult to understand that inherent in the ESM is a powerful tendency to acquire more competences and the right to intrude and interfere. In future, like its big brother, the IMF, the ESM will not only consider itself responsible for rescuing over-indebted member states, but will interfere as often as it can, use every opportunity to intervene, and tackle every new problem in the eurozone as soon as it appears.

Thus the banking and debt crisis in the eurozone is bound to deepen European integration. The ESM is as it were the foundation stone of a European economic government for the eurozone. However, it will be rather different to what many people had been hoping for. There is conditionality instead of coordination; there are spending cuts instead of a transfer union; and there is surveillance instead of agreement. That is the brave new world of a European economic government for the euro and this has got nothing to do with a transfer union in any way, shape or form. And in purely economic terms it may well be a good thing, as long as conditionality is not overdone and restricts itself to asking for a minimum amount of discipline on the part of the national economic policies that a common currency requires, whether one likes it or not, and which many countries in the eurozone were unwilling to come up with on a voluntary basis.

But in political terms the risks continue to loom large. Will the eurozone be able to cope with a conditionality regime of this kind? Will the countries concerned agree to being disciplined by conditionality on a permanent basis?

Can the eurozone take the strain? All these questions are of course based on the assumption that the euro can survive the current crisis, and will actually make it to safety. That is not going to be made any easier by the ESM. Quite the contrary.

IV

The Downside of the ESM: the Euro in an Insolvency Trap

In the long term the ESM may turn out to be the Trojan horse of a European economic government. But in the short term the ESM is going to destabilize the eurozone and increase the risk of speculative bubbles and financial crises. And in the short term the ESM will push the eurozone into an insolvency trap. Why should that be the case?

As the markets see it, two aspects of the ESM in particular determine its inner logic. On the one hand there is the fact that its loans have preference over those of the market (=seniority), and on the other hand the fact that from 2013 onwards the participation of private creditors will be a precondition for ESM credit assistance.

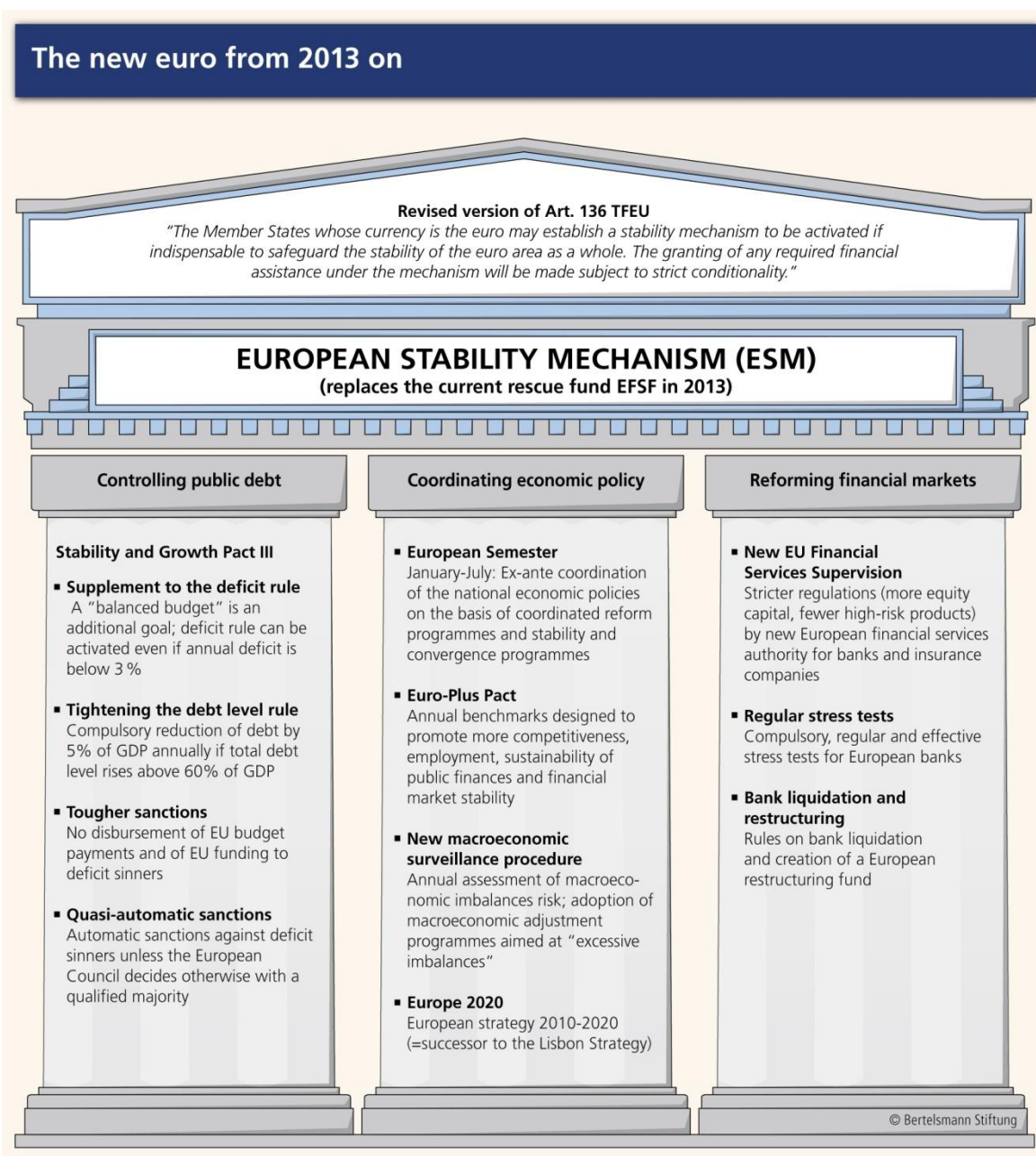
From these two aspects the markets deduce that there is an increased likelihood of debt restructuring after 2013. They take this to mean that policymakers are banking on deferring the requisite restructuring to the time after 2013 when the financial markets have quietened down and public opinion is no longer so excitable. Yet when all is said and done, markets tend to anticipate the future.

This is precisely what is happening at the moment. The rating of Greece was once again downgraded as a direct reaction to the ESM decisions, and Portugal has been forced to seek shelter under the old safety net on account of speculative attacks which have targeted its interest rates. And why should the markets stop at Portugal? From the point of view of a private creditor the provisional safety net is far more easygoing than the new ESM. It stipulates neither the second-tier nature of his debts nor the precondition of private creditor participation. Thus there is a genuine incentive for all private creditors to seek

protection under the old safety net before the middle of 2013. This is another reason why there is a kind of “everything must go” mood in the eurozone, and for this reason Portugal is only one pawn which will soon be followed by others. But if this happens, the old safety nets will not be enough. In financial and political terms, they cannot deal with challenges that go much further than Greece, Ireland and Portugal. In political terms this is quite simply due to the fact that every additional bout of credit assistance under the old safety net rules raises the prospect of tax-

payer participation in debt restructuring down the road.

Such risks currently deter policymakers from proceeding with the requisite restructuring, and so do fears that this might be the cause of a new banking crisis. If Greece were to have a “haircut” today, the involvement of the donor countries would be determined by their quotas and their share of the guarantees it has received. The guarantors would be faced for the first time with actual budget expenditure. The European debt crisis would start to cost



the taxpayer real money, and the amount involved would not be negligible.

For this reason governments are fighting shy of restructuring. So is the ECB, which, by buying up public debt from the crisis-ridden countries, has got itself into a situation where it is also in a cleft stick. Every additional euro heading for cover under the old safety net is simply helping to exacerbate the whole dilemma. The euro is well and truly in an insolvency trap.

V

The Danger of Speculative Attacks During Ratification

But risks are inherent not only in the self-inflicted insolvency trap. The politically risky plan to amend the treaty means that there may well be a threat of speculative attacks by the markets, and these can have a bearing on interest rates and endanger the euro.

The transition scenario adopted by the Council envisages a soft transition from the old safety nets to the new ESM. The EFSF will remain in force in its present form until June 2013. After that it will continue to operate until all of the loans that it has disbursed have been repaid in their entirety.

The two-year transitional period before the ESM becomes operational is due to the ratification of the alterations made to § 136. Even the simplified procedure stipulates that every member state has to give its assent to a treaty amendment of this kind.

Past experience tells us that such a procedure is fraught with a great deal of political risk. On this occasion there are two reasons why this may well be the case:

- On the one hand, on the national level there may well be follow-up debates

on what the heads of state and government have actually done to save the euro. In many EU countries the parliaments have the feeling that they have been ignored by their governments, and will use the ratification debates in order to voice their grievances.

- On the other hand, prospective ESM debtors will be looking at Greece, Ireland and Portugal, where national economic policy has to a very large extent been put into the hands of Brussels. Fears of suffering a similar fate could mobilize resistance in countries which are potential debtors. Instead of low interest and high growth rates, the euro is now leading to spending cuts and adjustment-related recessions. In many countries this may prompt people to reassess the euro. At the same time the parliaments of the ESM donor countries are afraid of an ongoing transfer of resources and will reject the ESM, since it is to their disadvantage and distorts the whole idea of a transfer union.

As far as the markets are concerned, all this leads to more than two years of political uncertainty and speculation about the credibility of the new euro. This used to be the task of the forex markets and of currency speculators. Their role has now been taken over by the capital markets and speculators who focus their attention on interest rates. For this reason interest rate volatility in the eurozone will continue to rise. Speculative ratification-related attacks will test the credibility of the euro in certain countries. Such attacks can turn out to be self-fulfilling prophecies, since for every debt level there is a putative interest rate which can force a country to seek protection under the safety net.

In order to enable the eurozone to reach the safety of the new euro, there is need for a transitional scenario that can deal with the problem of speculation. Without such a scenario the ESM will be doing the euro a great disservice.

VI

A Strategy for a Safe Transition

Markets anticipate the future by pricing it into the present. The net result of this is that the future becomes the present. This is the kind of logic on which a strategy for the safe transition from the old to the new euro should be based. Those who wish to secure the future of the euro with the help of the ESM must listen to its logic today (and not tomorrow). The markets certainly obeyed this logic when, in the days after the ESM decisions, their renewed interest rate attacks pushed Greece to the verge of restructuring and Portugal under the safety net.

To obey the logic of the ESM today and not tomorrow means tackling the requisite restructuring of obviously over-indebted countries of the eurozone now.

Whether this necessitates a “big bang” for the whole of the eurozone, as Daniel Gros has suggested, or whether a stepwise approach would be better is neither here nor there. But in the eurozone restructuring must no longer be considered to be as terrifying in political terms as the financial

markets and policymakers have for a long time made it out to be.

A simple way of doing this would be if the ESM were to become operational immediately. In other words, the current safety nets would be superseded by the new ESM without a transitional period. In this way all further safety net loans would immediately have first-tier priority over the loans of private creditors, and there would be private creditor liability as a precondition for further safety nets.

In order to ensure adherence to the provisions of the treaty, the European Council could adopt such a decision immediately, though initially for no more than a limited period. After the amendment of Art. 136 the ESM would be able to operate on an indefinite basis.

However, the old euro is not going to let us wait until the middle of 2013. If we want a new euro, we will have to introduce it NOW.

About the author:

The author is director of “The Future of Europe” programme at the Bertelsmann Stiftung and teaches economics at the University of Applied Sciences (FHM) in Bielefeld.

Responsible

Bertelsmann Stiftung
Carl Bertelsmann Straße 256
D-33311 Gütersloh
<http://www.bertelsmann-stiftung.de>

Dr. Dominik Hierlemann
dominik.hierlemann@bertelsmann-stiftung.de
Telefon +49 5241 81 81537

Joachim Fritz-Vannahme
joachim.vannahme@bertelsmann-stiftung.de
Telefon +49 5241 81 81421

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