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A three-pillar solution to the Eurozone crisis

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15 August 2011

The current Eurozone crisis shows no sign of abating. This column proposes a solution built on three pillars: A Eurozone Charter, a Eurobond Programme, and a Debt Restructuring Programme for insolvent countries.

In the current situation of the Eurozone, both the cost and the availability of market funding to financial institutions depend positively on the spreads and availability of funding faced by the national governments of the countries where these firms are domiciled.[1] This is the source of a strong *de facto* segmentation of financial markets which produces large asymmetries to the cost and availability of credit across countries, interacts negatively with the doubts about the state of government finances, and constitutes a tangible threat to economic recovery—especially for the weakest economies.

In the closer-to-ideal US monetary union, the situation is very different. The risk of default of a state government does not damage the integration of the US capital markets and is not a threat to the US dollar as the union's single currency. One key difference is that the US has a strong federal government. However, the possibility that the federal government bails out a state government is not the main reason why the US is more resilient than the Eurozone to concerns regarding the solvency of its member states. There are important differences regarding financial architecture which are worth stressing.

- First, in the US, non-bank financial markets are more developed and not segmented on a state basis.
- Second, there are more banks with branches located all over the union.
- Third, deposit insurance and the responsibility for bank resolution fall on federal agencies, implying much lower interconnection (if at all) between state governments' fiscal health and the creditworthiness of the financial institutions domiciled in each state.

In my view solving the current Eurozone crisis (a hybrid of bank and sovereign debt crises) requires working on two complementary fronts:

- Dealing with the *de facto* segmentation of the banking system (which is a structural source of instability and a potential cause and amplifier of national asymmetries); and
- Inducing the authorities to take the lead (over markets) with respect to deciding which countries are solvent and which are not, and to establish clear plans for each group.[2]

Insolvent countries should undertake a debt-restructuring plan, while the solvent ones should receive both the support and the incentives needed to guarantee that they undertake fiscal consolidation plans consistent with the preservation of their solvency. The procurement of the latter goal through a Eurobond issuing programme with fiscal consolidation strings attached is possibly the main novelty of the three-pillar solution sketched below.

The complementarity of the three pillars comes from their contribution to the reduction of uncertainty regarding the solvency of banks and governments in the Eurozone, to the viability of an incentive-compatible programme of fiscal consolidation, and to the coordination of expectations on a non-panic equilibrium in which the main Eurozone members remain solvent.

Here is my take on what would be needed to finally end the Eurozone crisis. I write it in the form of a "Charter" for brevity's sake.

Pillar 1: European Charter for well-capitalised financial institutions

- The banks receiving this charter will be under the direct supervision of a *Eurozone bank authority* which will run their deposit insurance scheme.

- The authority will be delegated all the regulatory, supervisory and resolution powers of the relevant national authorities.

This authority might act in cooperation with the existing national bank authorities in a way parallel to how the ECB acts together with the European System of Central Bank.

- The activities of this authority will count on pre- and post-funding coming from deposit insurance premia and levies on liabilities different from insured deposits charged to the banks under its jurisdiction.
- Initial, ongoing and/or contingent contributions from the national governments which will be determined by clear *ex ante* agreed burden-sharing rules based on the principle of coinsurance against potential unexpected losses.
- The authority will count on liquidity support from the ECB.

Pillar 2: Eurobond Programme with fiscal-consolidation strings attached

- The programme will be joined by the Eurozone governments considered solvent when admitted to the programme.
- Member countries will be assigned a *capital key* (share of participation) while belonging to the programme that will be initially fixed and subsequently adjusted (if needed) according to some objective commonly agreed criterion.
- The programme will set an entity in charge of issuing *Eurobonds*.
- The assets of this entity will be sovereign debt of the member countries, which will be issued simultaneously and with conditions (other than their price) identical to those of the issued Eurobonds.
- Member countries respond unlimitedly and collectively to the repayment obligations associated with the outstanding Eurobonds.
- The programme will place Eurobonds in the market following the mandate of member countries insofar as they do not reach some assigned upper limit to their issuing capacity, or lose their right to further issue Eurobonds in application of the rules specified below.
- Member countries will deliver an amount of matching national bonds equivalent to the Eurobonds issued by their mandate and, in exchange, will receive the revenue raised with the issuance of the corresponding Eurobonds minus some *stabilisation-contingent fees*.
- The stabilisation-contingent fees will cover the operational costs of the programme and the charge for the estimated underlying credit risk, and will contribute to the capital and reserves of the entity running the programme.
- Once these capital and reserves exceed a sufficiently high level, the excess income or reserves will be distributed as dividends to the member countries according to their capital keys.

Accordingly, if a country such as Germany makes small or no use of its Eurobond issuing rights but other member countries do and pay fees, then Germany will be a net receiver of income from the scheme, while the most intensive users of the facility will be net contributors.

- The dependence of the stabilisation-contingent fees and the upper limit to the issuing right of each member country on factors associated with its fiscal health will be instrumental to maintaining fiscal discipline while belonging to the programme. To perform this role, the fees will be structured as follows:

  a) Each member country $j=1,\ldots J$ will be assigned a *target* fiscal consolidation path $\{b^*(j,t)\}$ over a time horizon t=1,…,T, where $b^*(j,t)$ is expressed in terms of a relevant fiscal indicator (say, the ratio of primary general-government deficit to GDP or the ratio of total government debt to GDP). Simultaneously, it will be assigned a *maximum-deviation* fiscal consolidation path $\{b^{**}(j,t)\}$, with $b^{**}(j,t)>b^*(j,t)$, for the same horizon.

  b) Issuance of Eurobonds while the current fiscal path is within target, $b(j,t)<=b^*(j,t)$, will be subject to some *non-punitive fee* $f(j,t)$ made of two parts:

    (i) The first part will be an administrative charge that could be expressed as a percentage of the market value of the Eurobonds issued by mandate of country *j* at time *t*.

(ii) The second part will be expressed as a fraction (e.g. 50%) of the difference between the market value of the Eurobonds issued by mandate of country *j* at time *t* and the estimated market value of the matching sovereign debt that the country places with the programme.

c) All members of the programme exercising their right to issue Eurobonds will issue a minimal fraction of their sovereign debt directly in the markets so that actual prices may be used for the estimation of the market value of the sovereign debt placed with the programme.

d) For $b^*(j,t) < b(j,t) <= b^{**}(j,t)$, Eurobond issuance will be subject to a *punitive fee* $p(j,t) > f(j,t)$ which will be increasing in the deviation of $b(j,t)$ with respect to the target $b^*(j,t)$. The punitive fee will also be structured in two parts. Its dependence on the deviation $b(j,t)-b^*(j,t)$ can be achieved by making the second part equal to a *variable* fraction of the difference between the market value of the issued Eurobonds and the estimated market value of the matching sovereign debt. Such fraction will be increasing in $b(j,t)-b^*(j,t)$.

e) For $b(j,t) > b^{**}(j,t)$, country *j* will no longer be entitled to issue bonds under the auspicies of the programme. The details of the programme should be such that under most imaginable circumstances no country belonging to the programme reaches the bound $b^{**}(j,t)$. The idea is that accidental deviations from the target $b^*(j,t)$ (say, due to the unexpected arrival of a recession) may force a country to stay in the punitive region for a while but the programme will provide all the incentives for the country to quickly return to its targeted fiscal adjustment.

f) If, however unlikely, circumstances lead a country to exceed $b^{**}(j,t)$, the country may regain the right to issue bonds under the auspicies of the programme (perhaps after an established punishment period) if its solvency gets restored. At that point the country will be assigned some new target and maximum-deviation fiscal consolidation paths.

- The key elements of the Eurobond Programme should be designed with the main aim of anchoring expectations to a credible, incentive-compatible path of fiscal consolidation for each of its members:

a) Each country's fiscal consolidation path, crucially described by the initial values and revisions over subsequent time horizons of $b^*(j,t)$ and $b^{**}(j,t)$, should be specified in coordination with the European institutions currently in charge of coordinating developments in the fiscal area. A goal will be to achieve compliance with the Stability and Growth Pact.

b) The non-punitive contingent-stabilisation fee $f(j,t)$ should be such that the cost of funding under the Eurobond programme is comparable to what the cost of funding would be under no-panic market conditions in a context in which the target consolidation path is met and the corresponding country is expected to remain solvent in the medium and long terms.

c) The punitive fee $p(j,t)$ should encourage country *j* not to exceed its target fiscal consolidation path but, if such an undesirable event happens, the fee should still be compatible with a return to the target path (i.e., should entail better financing conditions than under exaggerated default expectations with a self-fulfilling potential).

d) The maximum-deviation consolidation path should be designed striking a balance between (i) allowing for some flexibility vis-à-vis shocks that may entail a sudden deterioration of fiscal health and (ii) protecting other programme members from the possibility that a non-complying member misbehaves, hits the boundary, loses its right to issue Eurobonds, and, in a worst-case scenario, ends up defaulting.

- The ECB will have the power to conduct transactions directed to support the prices of Eurobonds if they were subject to speculative attacks.

Pillar 3: Debt Restructuring Programme for insolvent countries

- The Debt Restructuring Programme is intended for selected countries whose current fiscal position is already too negative for inclusion in the Eurobond Programme.
- Part of the sovereign debt of these countries will be restructured or written-off, in principle at the cost of the

current holders of these debts.

- National governments will be free to extend loss mitigation facilities to the financial institutions under their jurisdiction that get affected by the programme. These facilities may go from the full assumption of the incurred losses against the national budget to the establishment of a more selective bank recapitalisation programme which only acts on financial institutions whose solvency gets compromised.
- If the write-off of debt of the restructuring countries were to cause losses to the ECB that cannot be sufficiently absorbed by its current capital, the ECB will be recapitalised.
- A restructuring country may gain admission to the Eurobond Programme after some punishment period (e.g. 5 years) and provided that its fiscal position is healthy at the time of admission.

References

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Tabellini, Guido (2011), "The Eurozone crisis: What needs to be done", VoxEU.org, 15 July.

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[1] This fact is empirically documented in a recent presentation of ECB executive board member Lorenzo Bini Smaghi (see here). See also Davies and Panetta (2011).

[2] This combination mixes elements of separate proposals made before by Allen et al (2011) and Tabellini (2011), among others.

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