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Does Europe have the means to guarantee itself? The Euro Zone States: a "Community of Destiny"

ABSTRACT

Following the European Council on 30th January last the issue was raised over the capability of recent European measures to provide the support required by Greece, Portugal and even Italy. The EFSF's loss of its triple A rating and the reticence of international institutional investors with regard to the co-funding option highlights the fragility of both the EFSF and the ESM, which will follow on. Based on the euro zone's profound economic and financial interdependence, a sound mutual support guarantee should rely on a community approach. Although long term Eurobonds are undoubtedly the best option, two other possibilities might be explored in more detail in the short term given the urgent nature of the situation: we might either combine the EFSF/ESM with a joint and several guarantee provided by the Member States or review the ECB's mandate to allow it to play its full role as lender of last resort.

Although they approved the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" and they came to agreement on the early implementation of the European Stability Mechanism (ESM), which will follow on from the European Financial Stability Facility (EFSF), during their meeting on 30th January last, the 27 Heads of State and government left an open question over the adequacy of these support measures. Given the difficulties encountered in the implementation of the aid plan to Greece and continuing doubts about the sustainability of the Portuguese, Italian and Spanish debts, there is increasing pressure on the part of the international community (IMF, World Bank) to strengthen significantly the European solidarity mechanisms. In this context the following paper endeavours to show that a mutual guarantee mechanism that is really credible might be the only one capable of providing the security that is vital to the revival of market confidence with regard to sovereign euro bonds and also with regard to the euro zone's stability.

1. THE ESTABLISHMENT OF A MUTUAL, CREDIBLE GUARANTEE IN THE COMMON INTEREST OF ALL OF THE MEMBER STATES.

Apart from allowing the so-called "peripheral" Member States to borrow at reasonable rates on the international markets[1], a mutual guarantee would be in the interest of all European States, including Germany, for at least three reasons.

Preventing the spread of the crisis via the banks

By reviving market confidence and reducing risk premiums on the peripheral countries' debts, a mutual guarantee mechanism would stop the crisis that is affecting some States from spreading to the rest of the euro zone via the European banking system. An important detail in the European crisis is indeed that most State securities are held within the euro zone. The rise in interest rates on the secondary markets is now reflected in a correlative depreciation in State securities held in portfolio by euro zone institutional investors (banks, insurance companies, pension funds). Although the reduction of the value of the Greek debt is not the only reason, the need for additional own funds on the part of European banks, estimated at €115 billion by the European Banking Authority, should be seen in the light of the contribution of more than €100 billion requested from private creditors as part of the plan to restructure the Greek debt.

1. Just for the record, on 20th January the 10 year rates seen on the secondary market lay at 6.5% for Italy, 5.3% for Spain, 7.4% for Ireland and 15% for Portugal. The Greek debt's secondary market lies at a "theoretical" rate of nearly 35% and it is estimated that following an agreement on the restructuring of this debt the main rate may return to around 10% None of these rates is sustainable long term in that they are much higher than the mid-term growth rate which supposes achieving a budgetary surplus equivalent to the difference between the interest rate and the growth rate in order to be able to stabilise the debt.

Within a context of stricter prudential requirements and lower investor interest in financial sector equities, the effect of this decline in banks' performance can be compensated for in only two ways: by reducing assets i.e. the sale of some equity and the reduction of loans to the economy or by recapitalising the banks through the national budgets. However either of these options would have a direct, negative impact on the sustainability of the debt of all Member States, since recapitalisation by the States leads straight to a matching increase in public debt and reductions in loans to the economy impede the revival of growth which, in itself, is vital to stabilise the debt. In this regard we should remember that household loans from banks in the euro zone have practically stagnated in real terms since 2009 and that loans by these same banks to non-financial businesses have contracted by 2.5% per year since 2009. These two factors go a long way to explain the most recent forecasts issued by the ECB, the World Bank and the IMF, which foresee a recession of between -0.3% and -1% in the euro zone in 2012.

Discouraging speculative attacks

In the event of the failure of negotiations in terms of the voluntary participation of the private sector in the plan to restructure the Greek debt, any type of forced restructuring[2] would have even greater negative effect on the rest of the euro zone: commercial banks would undoubtedly be forced to record higher losses than the 65-70% presently forecast in their results; some would also have to record losses in terms of the derivative products (CDS, Credit Default Swaps) they have sold; the European Central Bank (and therefore indirectly, the participating Member States) would also have to record a loss in its results in respect to the €55 billion of the Greek debt it holds; the ECB would no longer be able to accept Greek bonds (both State and private) as collateral (which, unless there was an exceptional ad hoc refunding operation, might mean the implosion of the Greek banking sector); finally other Member States could be the target of further speculative attacks, notably via the CDS market.

Warding off the disaster of an explosion of the euro zone

The worst scenario would however be if Greece was forced to quit the euro zone. This possibility, previously deemed impossible and unthinkable by the main euro zone leaders[3], now seems possible since the declarations made by N. Sarkozy and A. Merkel on the eve of the G20 summit in Cannes on 2nd November last[4]. The exit of a country from the EU (procedure introduced in paragraph 50 of the TFEU of the Lisbon Treaty) or a renegotiation of the treaties to enable an exit from the euro without leaving the EU itself would be an unprecedented regression in the history of European integration, the political effects of which would be sizeable. It would significantly weaken the credibility of EU institutions and politicians (arguably already diminished due to their lack of response to the recent crisis), and this precedent could trigger a domino effect, leading to the explosion of the entire euro zone. Above all the exit of a country from the euro zone would have disastrous economic effects both for the country involved and the Union as a whole.

For the country in question the ensuing devaluation would increase the weight of its external debt considerably; it would worsen trading conditions and lead to greater inflation. In spite of a temporary recovery in terms of export competitiveness, and the respite provided by the possibility of a monetary refunding of the debt, the short and long term interest rates would, in this context, be so high that economic growth would be lastingly penalised and it would be impossible to bring balance back to public accounts. Many businesses would go bankrupt, starting with the banks, whose results would suffer shocks, both in terms of assets and liabilities: a downgrading of the value of bonds in their portfolios (because of devaluation and/or the rise in interest rates), an increase in doubtful loans, a race for the counter and the closure of access to international refunding markets.

Because trade in the Union is highly interdependent, other European countries would suffer the aftershock of this economic upheaval by way of their trade balance and also the banking system. The 17 euro zone members, starting with those on the "periphery," would be open to aggressive speculative attacks on the securities markets (government and bank bonds) and non-member countries would also be in danger of speculative attacks on the foreign exchange market, similar to those that occurred when the European Monetary System collapsed 1992-1993.[5]

2. THE EFSF AND THE EMS, BOTH QUANTITATIVELY AND QUALITATIVELY INADEQUATE

The capacity of the EFSF and the EMS to rise to a possible increase in the aid plans to Greece and Portugal and even for the establishment of aid plans for other Member States, is proving inadequate both from a quantitative and qualitative point of view.

2. A forced restructuring like this could take the shape of a unilateral moratorium by the Greek government of its payments or of Greek legislation retroactively modifying the terms of the bonds' contracts. A specific legislative modification of the bonds' contracts would entail Greece deciding to re-introduce the drachma and to denominate the bonds in a drachma that has been devalued against the euro.

3. During a press conference on 14th January 2010, in response to a question about the possible exit of a country from the euro zone, Jean-Claude Trichet remarked "I don't comment on absurd hypotheses" and in an interview on 4th July 2011 with Focus, Jean-Claude Juncker again declared : "This idea is absurd."

4. "It is clear that the question being raised is that of Greece's European future. Does Greece want to stay in the euro zone or not?", Nicolas Sarkozy, 1st November 2011, "Wir wollen Griechenland helfen und wollen auch, dass es im Euro bleibt. Aber es gibt die einseitige Entscheidung Griechenlands und die hat die Situation massiv verändert.[..],Wir wünschen uns, dass Griechenland im Euro-Raum bleibt". Aber wenn Griechenland sage, „das möchten wir nicht, dann werden wir das respektieren." (We want to help Greece and we want it to stay in the euro zone. But Greece has taken a unilateral decision and this changes the situation enormously. We hope that Greece will stay in the euro zone. But if Greece was to say - we don't want that – then we shall respect that.") Angela Merkel 2nd November 2011.

5. A withdrawal by Germany (possibly with some members of the hard "core") would have equally disastrous effects. The "peripheral" countries remaining in the euro zone would witness a sharp devaluation of their currency (with all the accompanying negative effects mentioned earlier) and then with any idea of solidarity within the EU being explicitly relinquished, they would be condemned to default over their debt. The German economy would suffer terribly by way of its trade balance and its banking system.

Inadequate size

From a quantitative point of view the EFSF has a refunding capacity for struggling Member States to a total of €440 billion, €190 billion of which have already been committed in the plans set up for Greece, Portugal and Ireland, which means a remaining capacity of €250 billion against a total debt of more than €700 billion on the part of these three States. Should Spain be obliged to call on the EFSF, the residual lending capacity of the latter (i.e. without the Spanish guarantee) would total €190 billion against a total debt of the four beneficiary States of some €1500 billion. Finally should Italy also turn to the EFSF for help, its lending capacity (i.e. without the bilateral Italian guarantee) would only total €110 billion against a total debt of nearly €3400 billion.

At the euro zone summit on 26th October 2011 two options were therefore drawn up to increment the EFSF's capacity by bringing a leverage effect into play. The first option comprised calling on investors from outside the euro zone to provide the additional guarantees via a dedicated facility (the CIF – Co-Investment Facility), but the proposal met with few potential investors. The second comprised an issue of partial protection certificates by the EFSF (PPC-Partial Protection Certificates) to cover securities in the event of a default to a total of 20 or 30% of their nominal value. But this appeared to be unconvincing in itself, in that this coverage would already be significantly insufficient to restore investor confidence if a country like Greece were to face a haircut of at least 65%. A significant increase in the PPC coverage level, to 60 or 70% for example would reduce the desired leverage effect accordingly and the issue of the measure's overall capacity would arise again. Finally since PPC's can be exchanged freely between investors, this would mean in many respects that they are almost like CDS's with the all of the perverse effects that go with these types of derivative products[6].

Excessively feeble credibility

The EFSF's efficacy is also limited from a qualitative point of view since it is based on the sum of the Member States' limited bilateral guarantees. The main effect of this is that its credit standard depends directly on that of the guaranteeing Member States. Hence Standard & Poor's decision on 13th January last to downgrade nine euro zone Member States, including two which enjoyed a triple A rating (France and Austria), led to the ensuing loss of the triple A by the EFSF. This downgrading will lead to higher funding costs on the markets and as a consequence interest rates offered to the Member States that benefit from the EFSF's support will not be as good. Given the premium added to its own issue cost to define interest rates applied to EFSF beneficiary States, it is doubtful whether it will be able to offer loans at 3% , the rate deemed necessary by the IMF with regard to Greece for example.

The European Stability Mechanism (ESM) that is meant to take over from the EFSF mid-2012 will a priori be less directly dependent on Member States' credit rating in that it will enjoy €80 billion in own funds contributed by the Member States. However, these own funds, the payment of which certainly raises major political and budgetary issues, represents a modest buffer given the extent of the re-funding requirements on the part of the worst affected Member States, especially if the ESM's capacity, set initially at €500 billion, has to be revised upwards.

3. TWO MAIN IDEAS FOR A STRONG MUTUAL GUARANTEE MECHANISM

The introduction of euro bonds to replace the sovereign bonds of the various Member States would undoubtedly be the most effective way of restoring an efficient European bond market, as illustrated by the buying up of the Federated States' debt by the newly created American Federal State in 1790 by Alexander Hamilton. Quite apart from the political reticence that is still strong with regard to the federal leap that this kind of measure represents, it would require an implementation period that is not exactly compatible with the short deadlines faced by the euro zone, especially Italy[7]. Two main possibilities can be envisaged, in the short term, for the creation of a strong, mutual guarantee mechanism:

6. For more details on this issue see « La dette souveraine est-elle assurable ? », Philippe Huberdeau, 12th January 2012, Cycle des Hautes Etudes de l'Assurance

7. Italy has to refinance some €350 billion of its debt in 2012, including 90 billion in long term debt by April.

Back the EFSF/ESM with a joint and several guarantee

The first option would comprise no longer backing the EFSF and the ESM with Member States' limited bilateral guarantees, which lays the measure open to the decline in the situation of one or several Member States – instead they would be backed by joint and several guarantees provided by the European budget and/or all of the Member States[8]. This was in fact the solution chosen in 2010 for the first loans granted to Greece and the European Financial Stabilisation Mechanism managed by the Commission to provide support to Ireland and Portugal. It was also the solution adopted when the Commission raised funds to finance aid to the trade balance of non-euro zone Member States (Hungary, Latvia or Romania for example) or for the loans on the part of the European Investment Bank, designed to fund common interest projects within the Union. These measures continue to benefit from the best possible funding conditions on the markets.

A joint and several guarantee given to mutual support mechanisms could come up against the no bail out principle of one Member State by another as stipulated in paragraph 125 of the TFEU, but apart from the fact that it was possible to get round this hurdle with regard to the loans to Greece and for the ESFM by quoting paragraph 122 of the TFEU, which allows for financial aid in support of struggling Member State if there are "exceptional circumstances", paragraph 125 of the TFEU might also be revised by a unanimity decision by the European Council that would be "approved" (and not "ratified") by the Member States according to their respective constitutional rules (simplified revision process of the third part of the TFEU established by the Lisbon Treaty).

Putting an end to self-limitation of monetary sovereignty

The second option would comprise allowing the European Central Bank to intervene on the secondary markets as it started doing in a limited, temporary manner as part of its "SMP" programme (Securities Market Programme). This enabled the ECB to acquire a portfolio of some €200 billion in sovereign bonds i.e. the equivalent of 2% of the euro zone's GDP which can be compared with a total number of operations by the Federal Reserve of 11.1% of the GDP in the USA, of 15.2% in the UK for the Bank of England and 19.2% of the Japanese GDP for the Bank of Japan. Although this is not the ECB's declared goal, the SMP, together with a 3-year refinancing plan totalling €490 billion granted to the euro zone banks in December 2011 (the LTRO programme – Long Term Refinancing Operation), undoubtedly tempered the rates demanded from sovereign lenders in the euro zone.

This effect would undeniably be greater if the ECB received a clear mandate to intervene as lender of last resort of States in order to restore international investor confidence. The simple fact of announcing that the ECB was going to adapt its mandate in this way would in itself temper the rates in force on the secondary market. Given that paragraph 123 of the TFEU only explicitly prohibits the ECB from acquiring government bonds on the primary market, but not on the secondary market[9], this change in the ECB's mandate would not demand a modification of the treaties but a simple decision by the Council of Governors.

Although there may still be a great deal of reservation with regard to this idea within the Council of Governors, within the context of a potential downturn in the bond crisis and the imminent collapse of the euro zone, it would be absurd for those running the ECB to continue to defend such a narrow interpretation of the treaties, to the point of endangering the euro, i.e. the very "raison d'être" of the issuing institution. If the ECB stopped limiting itself, it would mean that it accepted the traditional view that monetary power is an element of sovereignty that cannot be reduced to a technical function alone.

CONCLUSION

Due to the high degree of integration of the euro zone's financial system, the no-bail out clause of one Member State by another as stipulated in paragraph 125 of the TFEU would appear to be unrealistic.

8. A guarantee of the EU's budget is the same as a joint and several guarantee of the all of the Member States since the 27 Member States must, according to paragraphs 310 and 323 of the TFEU, fund all of the EU's commitments.

9. Paragraph 123 TFEU does not formally prohibit the re-purchase of the Member States' debt securities on the secondary market – it only bans "purchasing directly from them" (i.e. on the primary market).

Given the uncertainty surrounding a possible exit from the euro zone, it would now appear urgent to set in place strong mutual guarantee mechanisms based on Community institutions and not on weak intergovernmental mechanisms. Politically speaking the introduction of a joint and several guarantee would be a logical *quid pro quo* for the strict budgetary discipline rules adopted recently as part of the "six-pack"[10] and the "community of destiny" decided upon when the European Community, then the Economic and Monetary Union were set in place.

10; The "six pack" is a series of six legislative acts comprising five regulations and one directive, approved by the Council and the European Parliament to strengthen economic supervision and the budgetary discipline of the euro zone, notably by including the possibility of imposing sanctions after adoption by a reverse qualified majority (i.e. automatic adoption except if a qualified majority of Member States are against it). This came into force on 13th December 2011.

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