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# Is the EMU ready for future shocks? An overview of available backstops

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**In recent years much has been accomplished to make the EMU more resilient to banking crises, sovereign-debt crises or balance-of-payment crises. Several 'backstops' or financial safety nets were progressively put in place to absorb the shocks that could have otherwise broken the EMU as a system. These substantial advances reflected a gradual, trial-and-error approach rather than a grand design that would have completely overhauled the EMU architecture. While flexibility and realism have advantages, complacency is a clear risk. With no roadmap to follow, efforts to complete the architecture of the EMU may fade with time. Maintaining a sense of direction is crucial while potential vulnerabilities remain.**

Since 2008, different financial backstops have gradually been introduced to better cope with the economic crisis. These backstops have ensured enough flexibility to prevent the EMU from breaking down in the aftermath of a sovereign debt crisis, a large scale default in the banking sector, a severe disruption in the payment system or in flows of capital in the eurozone.

This contribution explores how the EMU can cope with present and future economic shocks given its present architecture. First to be addressed: the framework gradually put into place for the backstops from the beginning of the crisis onward. This will be followed by some general – but certainly far from exhaustive – comments on their adequacy, with particular focus on the governance, rationale and possible shortcomings of the instruments available.

## AN OVERVIEW

Table 1 (page 2) provides an overview of the backstops put in place to deal with the different – but interconnected – dimensions of the crisis affecting the eurozone. The crisis is broken down into three types of event: (i) banking crises that are often tied to prolonged periods of excessive credit growth and/or asset bubbles; (ii) fiscal or sovereign-debt crises originating with fiscal imbalances; and (iii) balance-of-payment crises linked to current account imbalances or sudden stops but usually associated with banking or sovereign debt crises.[1] This breakdown of the crisis is far more blurred than the reality but allows for a simple overview.

Table 1: **Available backstops in the eurozone**

| **Shocks or crisis** | **Liquidity** | **Solvency** |
|---|---|---|
| Banking | - ECB: Emergency Liquidity Assistance (ELA), Long Term Refinancing Operations (LTRO)<br>- National Government guarantees<br>- *? Supranational deposit guarantee* | - Resolution including bail-in principles<br>- Single Resolution Fund (SRF)<br>- *? Common backstop to SRF*<br>- National fund and ESM Direct bank recapitalization |
| Sovereign | - European Stability Mechanism (ESM) precautionary financial assistance + ECB (Outright Monetary Transactions) | - Debt restructuring (private sector involvement/ *? official sector involvement*) |
| | EFSF/ESM/IMF programme | |
| Balance of payment | - Emergency Liquidity Assistance<br>- ECB liquidity (increased net Target 2 liability)<br>- Official assistance flows (EFSF/ESM/IMF) | - *? Elements of a 'fiscal union' (eurozone shock absorption mechanism/contractual arrangements)* |

Legend: items in red and italic following a question mark represent hypothetical instruments currently being debated.

A distinction is also drawn between liquidity and solvency crises. Caution is also warranted because it is extremely difficult to distinguish in practice between liquidity and solvency issues. Both are connected, as liquidity crises typically relate to some solvency concern. Moreover, mismanaged liquidity issues easily morph into solvency problems. This categorization is mostly useful because the backstops themselves are often designed in principle to address one or other issue separately.

## Banking Crisis Backstops

The eurozone's capacity to deal with a shock to its banking sector is not merely theoretical. The ECB comprehensive assessment that will be performed in 2014 will include a stress test – in essence a simulation of a shock. The exercise is not only preventive but also corrective in nature. It should promote the transformation of the European banking sector by fostering recapitalization and the resolution of banks that fail to meet capital requirements. One key question revolves around the actual recapitalization needs of the banking sector and the available absorption capacity of resolution tools – financial markets, the banks themselves (via bail-ins), the Single Resolution Fund (SRF) and existing public backstops.

For many observers at this stage of negotiations, the Single Resolution Mechanism's (SRM) design is unsatisfactory because its decision-making process is too complex and the resolution fund lacks a common fiscal backstop. As a result, many fear this setup will not allow the ECB to be sufficiently bold in its forthcoming assessment.

Although the decision-making process on the resolution of banks is rather complex and ultimately lies in the hands of finance ministers, it could nonetheless be workable. The governance balances technocracy (the Single Resolution Board and the Commission) with politics (ECOFIN). If the SRM does indeed fall short of being a true, 'single' authority functioning as an agency, this setup should nonetheless make it possible to take prompt decisions when required. Given that national fiscal resources would be on the line in the short term, it seems unrealistic to grant exclusive authority to the Commission and the Board for now. The governance of the ESM, which may also be required to take urgent decisions, actually presents stronger intergovernmentalist limits.

The second major concern is that the Banking Union would lack a proper common fiscal backstop. The vicious circle between banks and sovereigns would be reinforced by the absence of common risk-sharing mechanisms. However, the main focus of the ECB exercise should be the restructuring of unviable banks that present structural profitability problems. And solvency problems should not be dealt with using bailouts (which require fiscal backstops). If capital shortfalls are detected, then banks will be required to raise capital. But failure to raise capital above the current regulatory minimum[2] would in principle imply that the bank's fundamentals are lacking, indicating insolvency. In this case, before any public support can be granted, a restructuring plan would first have to be submitted to the Commission specifying how bail-in measures would limit the aid to a minimum.[3] The bail-in's priorities would be equity then subordinated debt, possibly followed by senior debt – unless the Commission estimates that the shortfall is so substantial that it could cause a disruption of financial stability.

There is much uncertainty regarding the precise recapitalization needs of the banking system in Europe because many questions remain open regarding the exact parameters the ECB will use when it conducts its assessment.[4] It is thus difficult to judge how much public funding may ultimately be necessary. In the short term and before the SRF reaches a considerable size, the available private resources may be insufficient. If so, the ultimate backstop will remain national taxpayers. This does not, however, preclude the ESM stepping in as a common backstop by making use of its direct bank recapitalization instrument to share a part of the burden if it becomes too great for the sovereign.[5]

While it falls short of an ideal design, this transitory resolution setup may be workable. The EMU will have to rely on the executive boldness of the ECB, which will hopefully act as a strong supervisor. In the longer term, especially when the banking system is hopefully brought back to health, the governance and fiscal backstops of the Banking Union could be improved to better deal with future crises.

## SOVEREIGN-DEBT CRISIS BACKSTOPS

### *For a (pure) liquidity crisis – the ECB's Outright Monetary Transactions*

Liquidity issues attracted much attention at the height of the sovereign debt crisis when several countries experienced the rapid and seemingly contagious rise of their borrowing costs. Some economists argued that a self-fulfilling liquidity crisis was underway as the market speculated about the possible break up of the eurozone.

Initially, Eurobonds were discussed as a possible means to halt the contagion. In essence, a country would be able to borrow via Eurobonds or debt issuances benefiting from the shared guarantees of all other eurozone members. Numerous proposals were voiced, with none actually making it to the negotiation table.[6] Technically, Eurobonds proposals were probably ill-suited to addressing strict liquidity issues.[7] Their introduction may not have halted the self-fulfilling liquidity crisis dynamic. The limit set on the amount of debt that could be issued via Eurobonds may have offered a clear target for speculation. Moreover, once introduced, Eurobonds would have at best allowed a country to borrow under its market rate and thereby raised severe moral hazard concerns, or at worst been inefficient if the overall sovereign risk was transferred to its remaining national issuances.

Because Eurobonds were technically and politically questionable, the solution had to come from the ECB which – despite political tension about its statute – was a more obvious candidate for eurozone lender-of-last-resort. As it turned out, the mere announcement by the ECB in summer 2012 that it would 'do whatever it takes to save the euro,' which it concretized via the creation of the Outright Monetary Transactions (OMT) programme, has for now effectively managed to halt speculation about an imminent euro break up. Since the ECB has endorsed this lender-of-last-resort role, the refinancing conditions of countries under the most severe stress have eased considerably.

However, the governance of this backstop for sovereigns remains flawed.[8] In principle, a lender of last resort should be able to act on an unlimited and unconditional basis. While essentially unlimited, the ECB intervention is not unconditional. A country facing refinancing difficulties must first request precautionary assistance in the form of a credit line from the ESM.

A Memorandum of Understanding and a Financial Assistance Agreement would set the conditionality of potential ECB interventions. These conditions would have to be negotiated among eurozone finance ministers who ultimately hold the key to the door leading to potential purchases by the ECB. This may not be a smooth process to undertake in the midst of a crisis, when distinguishing liquidity issues from solvency issues would be extremely difficult. Germany holds a veto right in the ESM Governing Council and would, in particular, need to take a further stance from the Bundesbank, which opposes the very concept of the OMT. The negative judgment of the German Federal Constitutional Court on the OMT in February 2014 added another complication. The increasing uncertainty may moreover represent a significant stigma for any ailing eurozone country making a request in the first place.

A similar judgment than for the Banking Union's backstops may apply here. The decision-making is certainly not ideal and involves some risks, but remains workable as long as stakeholders cooperate. In a longer term perspective, this improvised patchwork should be turned into a more robust solution.

### *From liquidity to solvency crisis – ESM programme and debt restructuring*

Ensuring countries' solvency – i.e., the sustainability of public finances – will remain a key challenge for many years to come in the EMU. With aggregate eurozone public debt levels currently above 95% of GDP, public deleveraging will require continuous effort. Therefore considerable attention was devoted in recent years to strengthening fiscal discipline in the EMU.

In principle, as long a eurozone member complies with the European fiscal governance framework, it could benefit from the ESM's support if it face an adverse shock that destabilizes its public finances. This could in particular be the case following a banking crisis. However, contrary to the earliest phase of the crisis, the common backstop will probably not be first in line in the future. Some form of debt restructuring would be in order when mostly solvency rather than liquidity issues are involved. The ESM Treaty explicitly foresees the possibility of private-sector restructuring should a future debt sustainability analysis show that the country cannot service its debt in full. Collective action clauses in sovereign bonds contracts were made mandatory to facilitate such restructuring. Moreover, for large eurozone countries, a full bailout would anyway be inconceivable due to the limited size of the ESM. Finally, the European banking sector is, for the time being, greatly fragmented, with a strong 'home bias' for sovereign debt. Despite the downside of this fragmentation, it would greatly facilitate the parallel restructuring of both a national banking sector and sovereign debt because it limits contagion effects.

However, in a prolonged low-growth and low-inflation context, the reduction of debt levels relies on a long-term commitment to fiscal consolidation. This will involve important redistribution issues at national level. In extreme instances, the high level of debt and the burden imposed on young and future generations may be judged excessive and illegitimate. If national social and political forces intend to take more radical measures to reduce the national stock of debt by restructuring it instead of relying on fiscal consolidation only, the eurozone would enter into uncharted territory.

## BALANCE-OF-PAYMENT CRISIS BACKSTOPS

The extent to which the euro crisis qualifies as a balance-of-payment crisis is debatable. It may in particular be argued that the imbalances affecting the eurozone merely reflect the other dimensions of the crisis – in particular the banking crisis. Accordingly, the backstops for balance-of-payment crises overlap the ones that exist for banks and sovereigns (see Table 1). Indeed, the major backstop that mitigated sudden capital outflows was public inflow – especially eurosystem refinancing, i.e., central bank liquidity.[9] This rightly shows that the solution of banking sector issues is the priority for unwinding exceptional liquidity provisions, fostering financial (re)integration, and ultimately allowing private flow back to the eurozone countries most negatively affected by the imbalances.

However, next to banking issues, competitiveness imbalances also represent a challenge. The macroeconomic imbalance procedure introduced in 2011 as part of the strengthened European economic governance framework reflects this concern. The excessive wage and price inflation that followed the introduction of the euro significantly explained the deterioration in the competitiveness of crisis-hit economies. This would call for a significant 'competitive devaluation' or 'relative disinflation' backed by the necessary product and market reforms.

Yet such an adjustment bears potential social costs for which no backstop other than the strictly national ones exists. A currency devaluation (or a eurozone exit) could have performed this absorption function but within the eurozone no such flexibility exists. As a result, no common instrument is currently available to mitigate the cost of the necessary adjustment following the shock that sudden stops imply. Addressing this void would involve developing instruments that would be part of a fiscal union. Yet proposals for a fiscal union – conceived as building block towards a 'complete', 'genuine' EMU – have so far largely been sidelined.

In particular, a mutual insurance mechanism could help absorb shocks and smooth out business cycles. However, any scheme involving automatic insurance against adverse shock will be extremely difficult to implement at this stage. The insurance mechanism would create moral hazard issues and its automaticity would make the conditionality of the transfers difficult to establish. Many fear that supposedly temporary automatic transfers may actually become permanent. An insurance mechanism is also best put in place under a veil of ignorance, when risks are perceived to be nearly equal for all countries, and their realization a distant, uncertain prospect. In the current situation – with the ongoing crisis unresolved – risks have already materialized as shocks for several countries. An unwinding of the accumulated competitiveness imbalances therefore seems to be a prerequisite.

In order to promote long-term convergence, the eurozone may still need a financial instrument that would both facilitate the correction of the imbalances – rather than focusing solely on their prevention – and mitigate the shock experienced by the countries most hit by the crisis. The ongoing discussion on contractual arrangements offers such an opportunity.[10] Contracting countries committing to structural reforms advocated by the EU would benefit from a limited, timely, targeted and temporary transfer scheme. There would be – by design – no moral hazard issue since contractual arrangements would be calculated to speed up and not slow down the adjustment process (these are contracts and not insurance policies, which would involve close monitoring). Selected recipient countries would thereby be contractually bound to implement the labour- and product-market reforms that aim to facilitate the adjustment necessary for their own sake but also for the EMU as a whole. The financial support for the necessary adjustment phase required in some countries could mitigate some of the social and political costs involved in their competitive adjustment process.

Quite obviously, the financial support attached to contractual arrangements will not match the benefit of restoring normal lending conditions and reversing financial fragmentation in the eurozone. Therefore a functioning banking union remains the top priority. Yet these targeted and timely public transfers could be a useful complement in the short term – say five years – by the time the most pressing competitiveness and banking issues are addressed. The experience gained with this mechanism could then possibly serve as a basis for more ambitious shock absorption schemes as part of a fiscal union.

## Conclusion

In recent years, much has been accomplished to make the EMU more resilient to crises. Several backstops were progressively put in place to absorb the shocks that could otherwise have broken the EMU as a system.

In the banking sector, the ECB ensured sufficient liquidity was made available to financial institutions. For more severe solvency issues, the forthcoming establishment of a Single Resolution Mechanism along with new bail-in principles should allow the ECB to effectively reinforce its central role in bringing the banking sector back to health. A Single Resolution Fund will be gradually built up. In the short term, the fiscal backstop will remain national but the ESM could also be used to directly recapitalize banks if necessary. Regarding sovereign debt risks, the ECB's OMT in combination with the ESM can fend off the most severe self-fulfilling liquidity risks. The ESM may be used in the event of a sovereign debt crisis, but, contrary to earlier bailouts, future ESM programmes would probably involve debt restructuring with Private Sector Involvement.

These substantial advances followed a gradual, trial-and-error approach rather than a grand design that would have completely overhauled the EMU architecture. While flexibility and realism have advantages, complacency is a clear risk. With no roadmap to follow, efforts to complete the architecture of the EMU may fade with time. Maintaining a sense of direction is crucial while potential vulnerabilities remain.

Some of these vulnerabilities are associated with the governance of the backstops. It is understandable that Member States are not willing to concede strong executive powers at EU level. Yet these are necessary for most of the backstops. The fact that the ECB, which disposes of strong executive powers, manages several of the backstops in the EMU is no coincidence. It's risky to involve high-level politics in decisions on the resolution of banks, or to authorize the ECB to purchase sovereign bonds. Moreover, a comprehensive backstop to the Banking Union's common resolution fund is desirable. The greatest question mark remains over the desirability of a fiscal union in the EMU. While the crisis triggered the creation of backstops for banks and sovereigns, no European mechanism directly mitigates the social cost implied by the adjustment process in eurozone countries most hit by the crisis. Contractual arrangements – presented as a building block towards such a fiscal union – are the only elements still on the European Council agenda, and the debate should integrate this dimension.

Overall, the current EMU backstop framework is not ideal but is workable. Different backstops exist and many instruments can be quickly expanded if necessary. However, this risk management exercise must be pursued by considering all risks and available options and by learning from past mistakes. The overarching objective should be to increase the EMU's resilience in all possible dimensions.

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## ENDNOTES

[1] The definition is from – and the (updated) associated table is inspired by – Bijlsma, M., Vallée, S., (2012), 'The creation of euro area financial safety nets', Bruegel Working Paper, 2012/09, July 2012.

[2] Common Equity Tier 1 should represent 4.5% of the bank's risk-weighted assets as of January 2014 according to the Capital Requirement Directive (CRD IV) and Capital Requirement Regulation.

[3] According to the State Aid guidelines (see Banking Communication 2013/C 216/01) that will apply before the harmonized framework of the Bank Recovery and Resolution Directive enters into force in 2016.

[4] See Merler, S. and Wolff, G. (2013) 'Ending uncertainty: recapitalization under European central bank supervision', Bruegel Policy contribution, Issue 2013/18, December 2013.

[5] The new instrument must not exceed €60 billion but this amount is revisable. See ESM (2013), 'ESM direct bank recapitalisation instrument – Main features of the operational framework and way forward', 20 June 2013.

[6] Most notably: the Blue bond proposal (Delpla, J.,von Weizsäcker, J., (2010), 'The Blue Bond proposal', Bruegel policy brief, Issue 2010/03), the European Redemption fund proposal (German Council of Economic Expert, (2011) 'Euro area in crisis, Annual report 2011/12', annual report of GCEE, chapter 3), the Eurobills proposal (Hellwig, C., Philippon, T., (2011), 'Eurobills, not Eurobonds', available at: http://www.voxeu.org/article/eurobills-not-euro-bonds). For a broad overview and comparisons see Claessens, S.,Mody, A., Vallee, S., (2012), 'Paths to Eurobonds', Bruegel Working Paper, 2012/10.

[7] We are not discussing here the merits of other forms of Eurobonds conceived as debt instrument backed by a genuine eurozone fiscal capacity. Preventing contagion and self-fulfilling liquidity crises was the core rationale for Eurobonds based on shared guarantees.

[8] What follows is a summary of the argumentation made in Vanden Bosch, X. (2012), 'Preventing the rise of sovereign borrowing costs in the eurozone: what can the ESM and ECB achieve?', Egmont Paper 56, November.

[9] Which explains Target 2 imbalances. See Merler, S., Pisani-Ferry, J., (2012), 'Sudden stops in the euro area', Bruegel Policy Contribution, Issue 2012/06, March 2012.

[10] This possibility is explored in Vanden Bosch, X. (2013), 'Contractual arrangements: the overlooked step towards a fiscal union', European Policy Brief 18, Egmont, December.