The Greens | European Free Alliance
in the European Parliament

A comprehensive emergency response
to the Eurozone Crisis

Group discussion paper

1 December 2010

This paper is complementing the one on economic governance, dated 17 November 2010

1. Why do we need an emergency response?

The Greek episode of the Eurozone crisis in the first half of 2010 created awareness and a sense of urgency on the need to establish more robust economic governance for the EU. However, the legislative process is such that the package is unlikely to be legally in place before the summer of 2011. On top of that, the EU emergency response to the Greek crisis, in the form of the European Financial Stability Mechanism (EFSM, community-driven) and Fund (EFSF, inter-governmental), amounting together to a maximum € 500 Bn (topped-up with 250 billions Euros committed by the IMF), is supposed to stop providing any new emergency loan in 2013 at latest. As recent developments around Ireland have shown, the EU needs to find before those processes will be complete, an emergency response that enables a sustainable resolution of the crisis; this may also force reconsidering a number of aspects of the current legislative proposals for the economic governance.

Three main elements should be taken into consideration

- First, the measures taken since the beginning of the financial crisis have so far failed to contain the crisis and to ring fence its effects. **Indeed, after a first round of actions including re-capitalization, guarantees and liquidity measures, the Greek and now Irish emergency responses amount to a second and third round of bail-outs for the European banking sector**, whose resilience and solvency remains a matter of concern. At the moment, the Irish banking system is in extreme distress with the Irish government fearing that it may need to inject substantial resources on top of the € 60 Bn it has already used to recapitalize the sector[1]. Unlike the Greek case, where government mis-management was a major cause of the crisis, Ireland's worst abuses are in the private banking sector, which

[1] Several analysts have repeatedly pointed out that the black hole of the Irish banking system has not been yet purged; the figure currently quoted for new bail-out of the Irish banks is € 85 Bn.

lent irresponsibly during the real estate boom phase. In both cases however, EU banks were highly exposed[2]. Therefore, while emergency rescue packages are presented as sovereign bailouts, their real objective is to keep the European financial system from imploding. Moreover, under the current conditions, these bail-outs externalize the costs of exposures to insolvency of core euro area banking systems to EU taxpayers; those of vulnerable Member States constitute the first line of victims, through drastic austerity measures while those of other Member States remain exposed to the impact of a potential non-repayment of the emergency loans extended by their governments.

Table: Some key data on debt, as of end 2009

All in % of GDP	**Ireland**	**Greece**	**Portugal**	**Spain**
debt	64.5	113.4	77.2	55.2
Deficit	-11.7	-12.7	-9.3	-11.4
gross external debt position	979.4	168.2	232.7	168.1
net external debt position	75.1	82.5	88.6	80.6
government external debt	70.6	78.9	74.9	47.3
net international investment position	-73.1	-82.2	-111.7	-93.5
gross external liabilities	407	188.4	281.3	214.1

Source: Ricardo Cabral, VOXEU.org

- Second, **there is solid evidence that austerity measures implemented in an emergency mode across member States are not delivering the results that were expected.** For various reasons (recession, lag-time of fiscal reforms, under-estimation of the deficits) the Greek and Portuguese austerity programs are not performing as planned. Moreover, the Irish government was praised for having anticipated its fiscal consolidation program; after nearly two years of drastic and self-imposed austerity it now joins Greece as the first euro area countries to fall into a double-dip recession.

  This should not be surprising, as according to the rationale of austerity plans been implemented in Greece, Ireland and other euro area vulnerable Member States', the economic recovery, which should enable a sustained reduction of the debt levels, has to be mainly driven by external demand. However, it should be pointed out that such a scenario appears unlikely at best[3]. Therefore, there are

[2] A synoptic document on the European Bank's sovereign debt exposure is available on line at the address: http://www.ft.com/cms/s/0/c4b5f456-ee7e-11df-9db0-00144feab49a.html

[3] In the current context the only way to ensure an inflexion point in the dynamics of public and private debt at the same time is through a particularly strong external demand[3] which in the current context is highly hypothetical. In the same rationale, certain Member States where aggregated demand has increased less than the average, rely heavily on foreign net demand to absorb their supply capacities. This is highly problematic as several Member States have been experiencing a strong reduction of their levels of capital imports and most emergent countries as well as Japan will maintain high current account surpluses, while the US is intending at the same time to reduce its current account deficits. In such a context a beggar-thy-neighbor policy is a dangerous option. *If nominal and real depreciation (appreciation) of the deficit (surplus) countries fails to occur, the deficit countries' falling domestic demand and the surplus countries' failure to reduce savings and increase consumption will lead to a global shortfall in aggregate demand in the face of a capacity glut*. Levels of indebtedness paradoxically could increase in the attempt to pay them down if most economies intend to export their way out to

strong risks that other Member States and in particular Portugal and Spain which are already under heavy pressure in the bond markets could experience in the short term similar developments as Ireland. Such a risk becomes particularly important if economic general conditions do not significantly improve during the next two quarters[4]. There are however strong doubts that such a significant and rapid improvement could happen given the current economic international context[5].

- Third, extensive new bail-outs of Spain and Portugal could deplete the resources available through the current EFSF/EFSM/IMF framework without plugging the leaks[6].

In such conditions there is no time for waiting until 2013 for the establishment of a permanent debt resolution mechanism. New and more comprehensive actions are needed well before. As it has been pointed out accurately by the Financial Times:

"*saving the banking system, however, is not the same as bailing out extant institutions; nor should taxpayers give up even more of their blood to the walking dead. Yet this is what Ireland is being asked to do – borrow money from the EFSF to raise the banks' equity. Doing so would be an insult to the Irish people (whose incomes will be mortgaged to pay the loan back) and a gratuitous one at that: it defies logic to claim that adding to Dublin's debt will seduce markets back to Irish sovereign bonds. So Ireland – and Europe – must confront the prospect of an inevitable string of bank restructurings. Giving away more capital now will weaken states' ability to deal with the problem when there is no more time to be bought. Europe does not yet seem willing to give up a diabolical bargain that has core states lend to peripheral ones so that they can support their banks, all to save financial institutions in the core from losses. This game of bail-outs on the sly cannot be sustained for much longer.*"

Clearly, a unilateral default could trigger financial panic and speed up a systemic crisis, but on the other hand the current approach based on case-by-case bail-outs and far reaching austerity measures without debt restructuring is not an option either.

2. Guidelines for tackling the current challenges

In a nutshell, for the last twenty years, in too many parts of Europe, the growth model has been mainly driven by consumption, real estate investments and financial speculation, all of it financed by a substantial and unsustainable private and public debt expansion. This was the case in several EU Member States and in the EU as a whole. In addition several Member States, including Germany and France failed to counter-cyclically rebalance public accounts during good years. Such a lack of forbearance reached its limits with Greece where public debt and deficits grew out

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recovery.

[4] Spanish economic growth stalled to zero in the third quarter, car sales fell 38pc in October, a 5pc cut in public wages has yet to bite, and roughly 1m unsold homes are still hanging over the property market. The problem is not the Spanish State as such: the Achilles Heel is corporate debt of 137pc of GDP, and the sums owed to foreign creditors that must be rolled over each quarter.

[5] Putting aside the impact of austerity measures across the EU there are strong concerns on the US prospects for the next quarters (see in particular the following document: http://ftalphaville.ft.com/blog/2010/11/18/409141/the-mathematics-of-inventories/

[6] For an analysis of funding capacities of the EFSF see the following documents: http://ftalphaville.ft.com/blog/2010/11/22/412426/more-bailouts-more-efsf-problems/ and http://www.ft.com/cms/s/0/14270bf8-f59e-11df-99d6-00144feab49a.html#axzz16CQzwhgQn

of control. This has reached a point where the overall debt level is in several cases above what can realistically be reduced or contained within reasonable limits. The responsibility for this situation is shared by both those (governments, enterprises, households) who borrowed beyond any sustainable level and by those who lent irresponsibly, hoping for substantial returns without risk, benefiting from the implicit (and ultimately effective) guarantee of governments. Therefore, both sides, lenders and borrowers must contribute to an orderly resolution. This is not only a question of a fair burden sharing, but also a question of credibility as simply adding debt to outstanding debt in order to feed 'walking dead' financial institutions do not work out solvency concerns.

Practically, Euro area Member States should adopt a comprehensive, far reaching and coordinated action plan aiming at achieving two main objectives. In a one hand this action plan should aim at restructuring unsustainable public debt in the three countries with the most unsustainable debt trajectories: Greece, Ireland and Portugal. On the other hand this action plan should simultaneously aim at restructuring and downsizing the European banking sector. Before the adoption of a permanent mechanism foreseen in 2013, an orderly restructuration process could be achieved by pre-emptive exchange offers and debt-to-equity swaps. Pre-emptive exchange offers basically consist on offering to the lenders to exchange their outstanding claims (short term and long term bonds) against new bonds with lower interest rates, longer maturity (length of the loan) and/or lower nominal value. Debt-to-equity swaps consist on exchanging debt claims on any financial institution against equity[7]. Both operations would help borrowers to reduce their debt charge and therefore restore solvency while allowing lenders to acquire a greater certainty of payout[8].

In any case public debt restructuring as well as the restructuring of the European banking sector should be completed with proactive EFSF/EFSM intervention in vulnerable Member States and with an enhancement of EFSF/EFSM resources. However any EU financial intervention should respect the following guidelines:

[7] As N. Roubini has recently argued in an extensive paper (N. Roubini, *An orderly market based approach to the restructuring of Eurozone sovereign debts obviates the need for statutory approaches.* Available on line at the address: http://www.roubini.com/analysis/138863.php) there is strong theoretical and empirical evidence that potential market failures and externalities which allegedly prevent orderly restructurings can be resolved through pre-emptive exchange offers. If a debt swap framework is well designed and coordinated (see foot note 8) such a mechanism should be able to deal with the 'rush to exit', 'rush to court' and 'systemic risk' externalities, as well as the free rider and credit default swaps (CDS) claims related concerns.

[8] As it has been argued by Avinash Persaud in a recent policy paper: "The precise price and maturity parameters would be so set to ensure that the expected return of creditors in the new bonds with the lower coupon but greater certainty of payout is similar to the older bonds with their highly uncertain prospect of payout. Creditors would not be taking any more of a haircut in the net present value of the bonds than the market has already discounted, but this haircut could cut Greece's interest bill from 5% of GDP to almost 2.5%. Without a debt swap or a similar move, the decline in the market valuation of the debt to sustainable levels is lost from debtors. Over three years, this reduction in the interest bill would represent half of the fiscal retrenchment required under the IMF program, allowing them to achieve a decline in the fiscal deficit from 13% to 3.5% in three years without cannibalizing the economy. Without a debt swap, but with the unprecedented 16% of GDP fiscal retrenchment proposed by the IMF, Greece's debt-to-GDP ratio would still rise to 150% by 2013, growth would stall and interest payments on the debt – 70% of which flow overseas – would crowd out all else. The $145 billion package would only have bought peace for a couple of years as a massive resource transfer took place and sustainability questions re-emerged. In defense of its "no-default plan", the IMF argues that a debt restructuring in Greece would cause a contagion across Europe. But a debt swap focused on lowering interest payments and preserving the nominal value of the bonds should be less contagious. Net interest payments as a percent of GDP are just 1.1% in Spain, the destination of most spillover concerns", '*A debt swap to save Greece and the* euro' available on line : http://www.voxeu.org/index.php?q=node/5065

- First, EFSF/EFSM interest rates must affordable. The Framework Agreement governing the EFSF/EFSM allows for a reasonable interest rate (requiring only a margin above the rate at which EFSF/EFSM could obtain financing in the market) for a three of five years maturity. The point is avoiding punishing any country, but instead to allow vulnerable Member States to reboot their macroeconomic fundamentals. This is only possible with realistic financial conditions attached to any bail-out. (See annex).

- Second, any EFSF/EFSM intervention in the framework of a comprehensive and far reaching restructuring and downsizing of the European banking sector should encompass the rapid definition of special insolvency regimes when such regimes have not yet been set at the National level. Special insolvency regimes should in particular allow Member States authorities to intervene financial institutions in order to restructure wholesale debt or converting it into equity while keeping or taking over operations such as deposits, savings and small business banking into 'good banks'. In any case, a coordinated action plan for debt restructuring requires an *ad hoc* coordinated burden sharing approach in order to avoid externalizing the total cost of exposure to insolvency to taxpayers and in particular tax payers of vulnerable Member States. With this respect the special burden sharing framework agreement for the North Baltic region provides an interesting benchmark of a coordinated *ad hoc* approach on burden sharing[9]

- Third, conditions that would equate to lowering minimum income and aggravating poverty and inequalities are unacceptable in our perspective. Rebalancing public accounts should not be done at the expense of the most vulnerable; one should on the contrary ensure that those who most benefited from the debt-driven economy contribute most.

- Fourth, there will be no healthy public finances in Europe without adequate taxation revenues as well as a build up of a Fiscal Union: this requires a) a quantum leap in fighting tax fraud and evasion, b) a more adequate contribution of corporations (CCCTB, corporate tax rate harmonisation towards a minimum of 25%), c) updating and enhancing progressive taxation in order to cover all sources of revenues and in particular capital revenues d) significant progress on new fiscal resources for member States (FTT, energy and other environmental taxation) the latter potentially becoming own resources for the EU e) Eurobonds for Member States' sovereign debt refinancing and Project Bonds for financing 'a European Green New deal', in other words, the ecological transformation of the European economy. On all of this, urgent action is required by the EU Member-States in the Council, which retain exclusive decision powers in that domain. Ultimately, the unanimity rule which still prevails in these matters - practically preventing any progress - must be replaced by qualified majority voting and co-decision with the European Parliament.

[9] For a description of the challenges and possible proposals on the stake of burden sharing see in particular : the online article 'Burden sharing in the EU : from theory to practice, available on line at the address: http://www.voxeu.org/index.php?q=node/5685

Beyond the current emergency, a long term approach requires a comprehensive reform and enhancement of the whole EU economic governance in order to tackle structural causes of the current crisis and in particular the broader stake of macroeconomic imbalances such as excessive private debt and excessive current accounts deficits and surpluses. General principles and benchmarks for such a long term reform on the EU economic governance are dealt with in the group discussion paper on 'Economic governance: a new framework for macroeconomic sustainability'.

As we Greens see it, the current situation is a "make or break" moment for the future or Europe's political integration. We do not underestimate the destructive potential of the current financial, economic and social turmoil for Europe's societies. We need to resolve this crisis combining the re-establishment of our public and private finances on sound bases *and* the investments in a Green New Deal that must enable Europe to be a pioneer in building a sustainable society of the 21st century. Failing that, Europe risks ending up as both unable to guarantee quality of life and social justice to its citizens and irrelevant as a global player.

The Green ECON Team
25 November 2010

Annex on EFSF interest rates

The benchmark formula for calculating interests rates of borrowing from EFSF is the following:

Effective Interest Rate = **1.2***(**3-year swap rate** (actually 1,9% for 3 years and 2,3% for 5 years) + **Margin (3% + 1% for any additional year)** + **Annualized Cost of Once-Off Service Fee around 0,15%**).

The 1,2 factor is explained by the over-collateralization requirement (EFSF can only lend 1euro for 1,2 borrowed)

In practice it would mean that for a 3 year loan the interest rate would be a few basis points above 6% and for a 5 years loan around 8,8%

´The crucial point (see below) is that this benchmark is not legally compulsory it is taken from the method used for the Greek loan. the EFSF legal framework agreement (see link below p. 4) says the following :

"The interest rate which will apply to each loan is intended to cover the cost of funding incurred by EFSF and shall include a margin (the "Margin") which shall provide remuneration for the Guarantors".

If this margin is 0,5% for instance, instead of the 3 to 5% indicated in the EFSF that would mean a 3 years loan of 3,5% and around 4% for a five years loan.

EFSF legal Framework Agreement

The framework agreement is silent on what the likely cost of funds will be but the FAQ which of course is not a legally binding document explains which rates should be considered the benchmark for costs of funding and what the margin will be:

"The blueprint for EFSF support - although not binding - is the financial aid package to Greece where, for variable-rate loans, the basis is three-month Euribor, while fixed rate loans are based upon the rates corresponding to swap rates for the relevant maturities. In addition there is a charge of 300 basis points for maturities up to three years and an extra 100 basis points per year for loans longer than three years. A one time service fee of 50 basis points is charged to cover operational costs."
point C7 of the EFSF FAQ
http://www.efsf.europa.eu/attachment/faq_en.pdf