

WILL A “EUROPEAN MONETARY FUND” BE CAPABLE OF MAINTAINING THE STABILITY OF THE EUROZONE?

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ABSTRACT

The debt crisis and the escalation of Greece's fiscal problems in 2010 forced European leaders to set up new institutions to rescue ailing eurozone countries. The European Commission endorsed a German proposal for establishing an International Monetary Fund-style rescue fund, the European Monetary Fund (EMF). As a result the European Financial Stability Facility (EFSF) created in May 2010 is to be transformed into a permanent rescue fund, the European Stability Mechanism (ESM) from 2013 on. Although these steps seem to have been necessary to deal with sovereign debt, several questions emerge concerning efficacy, feasibility, and moral hazard. There is strong opposition to the permanent rescue fund mainly among economists of the Northern European countries who argue that certain (Greece and some Southern European) countries' irresponsible spending and the profligacy of their governments have resulted in the government debt crisis. According to them these countries deserve strict punishment because their insolvency is due to their own mistakes, and financial assistance would be just adding fuel to the flames. This analysis lacks understanding or ignores the fact that the problem lies much deeper: in the fundamental problems of a monetary union. These problems and all their implications will hold until the European Monetary Union (EMU) has been transformed into a political union. The long-term stability of the eurozone, however, depends a lot on the attitude of the members, which would derive intrinsically from the nature of the union after transition. It is not the severity of the punishment that really matters.

Keywords: debt crisis, European Monetary Fund, European Stability Mechanism, European Financial Stability Facility, moral hazard

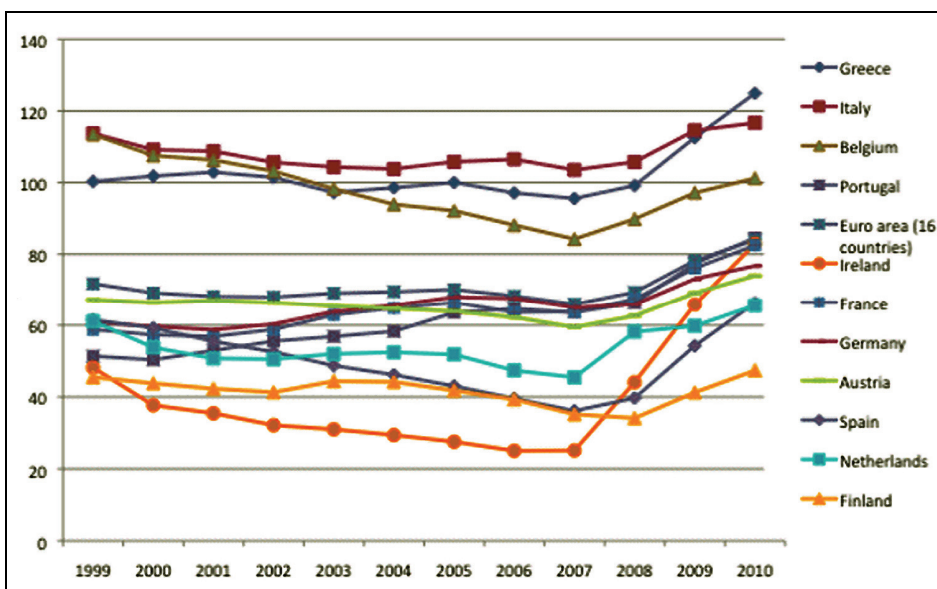
INTRODUCTION

Financial crises are followed by an increase in government debt (Fuceri and Zdzienicka, 2010). Europe was totally unprepared for the public debt crisis after experiencing consumption booms fueled by excessive credit. Greece, with a public debt of around 120% of GDP and government budget deficit of nearly 13% of GDP in 2010, was the weakest link in the chain (Figure 1). European leaders were forced to come forward with a rescue idea since an European instrument for assistance seemed to be indispensable. As a result the European Financial Stability Facility (EFSF) has been transformed into a permanent rescue fund, the European Stability Mechanism (ESM), even though it meant changing the EU Treaty. The new independent inter-governmental organization, also called as the European Monetary Fund (EMF), is to start its operation in June 2013. Although these steps seem to have been necessary to deal with sovereign debt, several questions emerge

concerning efficacy, feasibility, and moral hazard. Efficacy means whether an EMF would be able to deal with crises effectively.

Figure 1

General government consolidated gross debt



Source: *De Grauwe*, 2010

The question of feasibility is how the new institution could be financed and how it could work. Moral hazard stems from mutualization of risks that could lead to less fiscal discipline. These issues are worth addressing more thoroughly. This paper examines the pros and cons and attempts to view their different aspects. The EMF is planned to work under the concept of “enhanced cooperation” established in the EU Treaty. This paper aims to examine whether enhanced cooperation and a financing mechanism in which the main contributors are countries in breach of the Maastricht criteria can eliminate the moral hazard. It is obvious that sovereign default should be dealt with immediately. The euro area’s inability to help states at default risk has raised the need for a eurozone emergency funding mechanism. Examining the possibility of the long-run stability of the eurozone, however, requires deep analysis of the nature of the monetary union and highlighting the properties wherein its vulnerability lies.

**DISCIPLINE FAILURES AND MORAL HAZARD
WITHIN THE EUROZONE**

The sources of discipline failures within the European Monetary Union are members failing to maintain control of their finances. Yet sovereign default is not allowed. To handle these issues *Gros and Mayer* (2010) proposed to establish a permanent rescue

fund, the European Monetary Fund (EMF), which would be, similar to the International Monetary Fund (IMF), designed to conduct economic surveillance of the members besides monitoring and funding assistance programmes. As a measure of last resort the EMF would be capable of organizing an orderly default. Instead of preventing failure, as was necessary in the recent financial crisis, failure is to be made possible, which would lead to restoring market discipline. This assumes a system firm enough to cope with the impact of the failure of one member state. Mutualisation of risks by setting up funds creates moral hazard. There is strong opposition against the permanent rescue fund mainly among economists of Northern European Countries who argue that irresponsible spending and government profligacy of certain members are to blame for their difficulties (*Plenum der Ökonomen*, 2011). Their insolvency, such economists say, is due to their own misbehavior. A fund providing financial assistance would just encourage them to remain that way, in other words, it would create *moral hazard*.

Limiting Moral Hazard through Financing Mechanisms

According to *Gros and Mayer* (2010), moral hazard can not be eliminated but can be limited through a proper financing mechanism for the EMF. The basic principle of this is that the main contributors to the Fund should be countries breaching the Maastricht criteria, which would give them an incentive to keep their finances in order. The contribution rate is calculated on the basis of the stock of “excess debt”, meaning that the contributor should pay annually one percent of the difference between the actual level of public debt and the Maastricht criterion limit of 60% of GDP. Thus, in a state with a debt equal to 120% of GDP, this would equal 0.60% of its GDP. For excessive debt the calculation is the same, one percent annually of the difference between the actual level and the criterion level of 3%. In a country with an excessive deficit of 12%, this accounts for 0.09% of its GDP. The total contribution for a given country would be 0.69% of GDP. The contributions should be based on the above parameters since they reflect impending insolvency and liquidity risk better than market indicators of default risks, which would be reduced by the existence of an EMF. The Fund should be authorized to borrow in the financial markets with full and joint backing of the member states until it reached a certain threshold. Member states with strong public finances would not have to contribute since their backing the EMF gains significance in case a crisis breaks out.

Limiting Moral Hazard through Conditionality

The other way of limiting moral hazard is conditionality. *Gros and Mayer* (2010) argue that with the EMF in operation a crisis would be much less likely to arise owing to the conditionality which is to ensure that countries introduce tailor-made fiscal adjustment programmes and that their situation is monitored as a condition of calling on funds or drawing on the guarantee of the EMF above the amount they have deposited in the past (with interest).

Enforcement Mechanism

According to the design of the EMF, its enforcement mechanism will ensure countries act according to their commitments. Sanctions are strict and can cut off new funding or structural funds for a country or even cut it off from the eurozone

money market. Not implementing a previously agreed programme would incur considerable costs. An EU member state refusing to accept the decisions of the EMF can leave the EU and the EMU (ECB, 2009). Finally, a country can also be thrown out according to Article 7 of the Treaty of Lisbon.

MANAGING ORDERLY DEFAULT

Through the new Fund an orderly default of a member country that fails to comply with the conditions of an adjustment programme would be possible. In order to minimize default disruptions it was crucial to create mechanisms according to which the EMF could offer holders of debt of the defaulting country an exchange against new bonds issued by the Fund. The EMF could tie its guarantees to the 60%-of-GDP Maastricht limit on debt. The mechanism would be similar to the procedure existing in the USA for bankrupt companies that qualify for restructuring (Gros and Mayer, 2011).

THE VULNERABILITY OF A MONETARY UNION

Liquidity crisis caused by financial markets

For the members of a monetary union, joining does not only mean giving up their independent monetary policy (interest rate or exchange rate) instruments. According to *De Grauwe* (2011), it also means issuing debt in a currency over which they have no control. Thus they can be forced into default by financial markets. It throws light on the difference between the nature of sovereign debt in member and non-member countries, which makes monetary union member countries vulnerable. Assume investors were to fear that a non-member country were defaulting; they would get rid of the country's government bonds causing the interest rate to go up. Then they would sell the *currency* they got for their bonds in on the foreign exchange market. The exchange rate of this currency would drop until demand increased. The outcome would be that this currency would be bottled up in the particular country's money market to be invested in its assets, leaving the country's money stock (liquidity) unchanged. As a last resort, the National Bank of the country would be forced to buy up government bonds ensuring enough liquidity for the government to fund its debt. The same situation in a member country would end in a completely different outcome. After selling the bonds of the member country, investors in their fear of the country's default would be sure to decide to invest the acquired *euros* somewhere else, which means that the money supply of the particular country would decrease. Its government could not find the funds to roll over its debt at reasonable interest rates, so a liquidity crisis would ensue. The national bank of the country could not be forced to buy government debt and the government does not control the ECB, which could provide the liquidity. To sum it up, fiscal markets have enough power to force any member state into default. *Emerging economies* are familiar with this situation: when they borrow in a foreign currency they may experience a liquidity crisis caused by a sudden stop of capital inflows.

Solvency crises imposed by financial markets

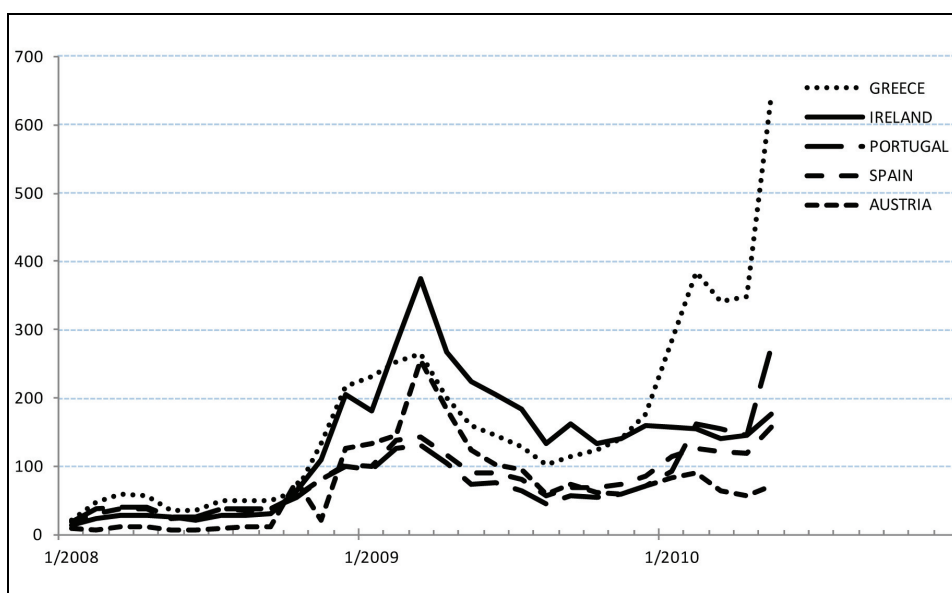
In the example mentioned above, the sale of a non-member states' currencies in the foreign exchange market will make the national currency depreciate, giving a boost to the economy and an increase to inflation. This does not happen in the member-country, since its bonds are sold for euros, which leave the country's money market. *De Grauwe* (2011) argues that there is a "devilish interaction" between liquidity and solvency crises. A liquidity crisis can turn into a solvency crisis with interest rates driven up. The investors' fear of insolvency can make the country become insolvent through self-fulfilling movements of distrust. This phenomenon highlights the vulnerability to financial markets' movements of monetary union member states in general. Market efficiency as a disciplining force, however, cannot apply to the financial markets since they are moved by sentiments (fear, panic, euphoria) and rating agencies.

Highly integrated financial markets

Highly integrated financial markets imply that government bonds of monetary union member countries are held to a significant degree outside of the country of issue. Bad equilibrium of member countries affects those with good equilibrium adversely. According to *Arezki* (2011), there are strong spillover effects in the eurozone. Bad news spreads via a complex transmission process, which makes surveillance and regulation complicated. It is impossible to isolate the financial problems of one country from the other members due to these external factors (*Figure 2*).

Figure 2

CDS Spreads for Selected European Countries and Greece Credit Ratings



Source: *Arezki et al.*, 2011

Lack of automatic budget stabilizers

The triggered liquidity and solvency crisis shown above will force governments to introduce austerity measures amid the recession. According to *De Grauwe* (2011), in a non-member state the higher budget deficit generates distrust, which prompts an *automatic* stabilizing mechanism—an important social achievement. Member countries, however, find it impossible to stabilize the business cycle by budgetary policies.

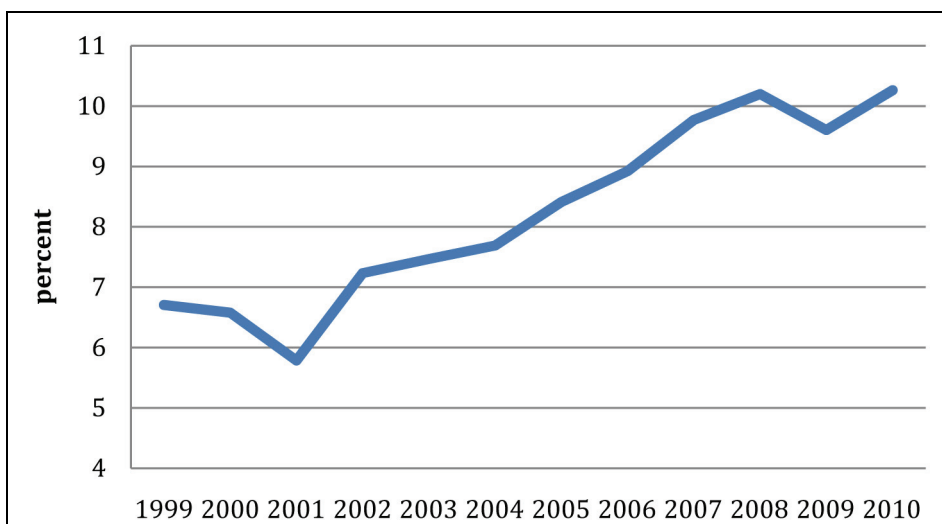
Competitiveness problems

The competitive position of member states has shown large divergences since 2000 (*Figure 3*).

Since the monetary policy tool of devaluing a currency is impossible for them to use, those that lost competitiveness bring down their wages and prices compared to those of the competitors by deflationary budgetary policies. This results in increases in budget deficits. Distrust of financial markets may lead to a liquidity crisis that will trigger a solvency crisis. Trying to improve competitiveness is extremely hard for these countries amid the recession with the increasing unemployment and being hit by banking crises and sovereign debt at the same time. The country gets stuck in the bad equilibrium with a downward spiral and high interest rates. Non-member countries, on the other hand, can issue debt in their own currencies thus can balance a loss of competitiveness by allowing their currency to depreciate in the foreign exchange market. They can avoid the bad impacts described above in ways member countries cannot.

Figure 3

Standard deviation relative unit labour costs in Eurozone (in per cent)



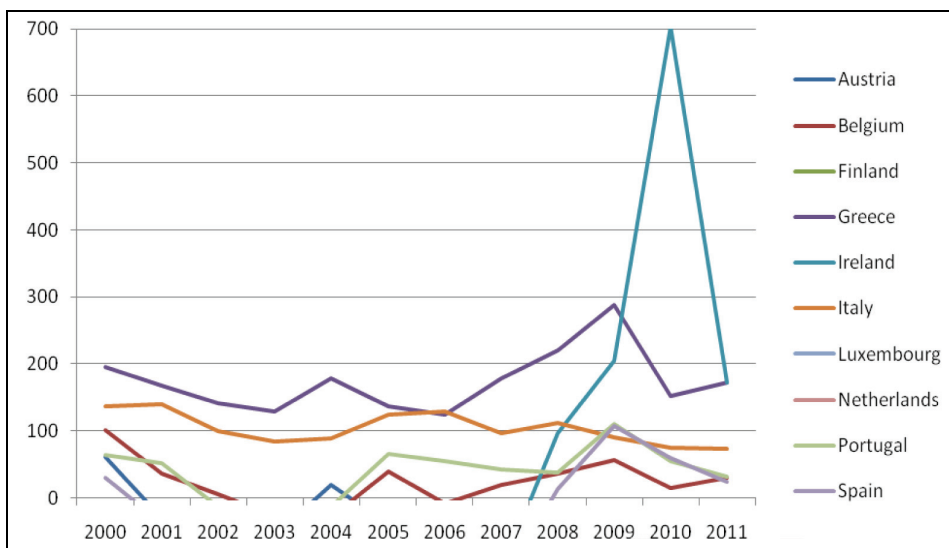
Source: *De Grauwe*, 2011

INTRODUCTION OF THE EUROBOND SCHEME

The joint issue of Eurobonds is another idea to guarantee the stability of the Euro area. *Boonstra* (2005) was the first to make a proposal for the issue of Eurobonds. Moving from national to central financing for all public debt would remove the possibility of raising debt on the financial markets separately. In *Boonstra's* scheme Eurobonds were to be issued by an independent "EMU Fund" and lent to the participating EMU countries at a premium over the Eurobond rate. This premium was to be based on deficit and debt deviations from the average levels of Germany and France. Only countries performing worse than Germany and France were to pay a premium. In *Figure 4* you can see a hypothetical case where the "EMU Fund" would have been introduced in 2000.

Figure 4

Total premium (basic points) over the EMU fund rate



Source: *Eijffinger*, 2011

The *Figure 4* shows the total premium over the EMU fund rate. The Eurobond solution is expected to offer market discipline, since this scheme would provide shelter from large swings in market sentiments and fiscal discipline, that is, these bonds would have to contribute to strengthening the enforcement of budgetary rules. Speculation is to be deterred. A large participation rate is vital for the Eurobonds to succeed, which is *politically* important. It means that this solution has benefits for both strong and weak member countries. Issuing Eurobonds jointly means that the participating countries become jointly liable for the debt, which would signal to the markets that they are serious about the future of the euro *Juncker* (2010) argues. Pooling the issue of government bonds enable the member

states to defend themselves against liquidity crises stemming from the fact that they have no control over the currency in which their debt is issued that I described earlier. The Eurobond scheme, however, creates the problem of moral hazard, and the resistance of countries that behave responsibly is understandable. Collective liability implies insurance and provides an incentive for countries to count on it and issue much debt. As long as this moral hazard holds, countries are unlikely to jointly issue Eurobonds. The other problem has to do with ratings. For states currently enjoying a AAA rating it would not bring any benefits if the scheme did not allow them to get the best obtainable borrowing conditions. The design of the *common* Eurobonds must eliminate the moral hazard and must be attractive enough for the members with good credit ratings. To design such a Eurobond it would be better to seek a combination of proposals (*De Grauwe and Moesen, 2009, Delpla and von Weizsäcker, 2010, Juncker and Tremonti, 2010*). This scheme would allow participating members to issue Eurobonds up to 60% of their GDP, which would create "blue" bonds. Anything above 60% would be issued in the national bond markets designated as "red bonds". The senior tranche (blue) would enjoy the best rating while the junior (red) would face a higher risk premium, which might be higher than the interest they pay currently on their total outstanding debt, reflecting the fact that the default probability on the red tranche is likely to increase. The other element of the proposal deals with fees. Pricing of Eurobonds would be related to the fiscal position of the countries participating in the joint issue. As a result a large new government bond market would be created with sufficient liquidity. Its attraction to foreign investors would help the euro become a reserve currency.

THE EUROPEAN STABILISATION MECHANISM (ESM) AND LONG-TERM STABILITY

To guarantee the future of the European Monetary Union strict reforms are needed. The EMU has to be made a more integrated fiscal union with strengthened fiscal rules regarding enforcement in particular. On this basis a permanent defense mechanism for the euro should be set up. From 2013 a permanent European Stability Mechanism (ESM), the "European Monetary Fund", will replace the European Financial Stability Facility. Besides this move joint Eurobond issue has been designed to guarantee the stability of the euro area. Setting up the EMF enables the eurozone to avoid *ad hoc* interventions or calling the IMF. The IMF has no mechanism for allowing orderly default, while within the EMF orderly default is allowed and prepared for. The moral hazard problem can be limited through conditionality. Considering the reasons that make a monetary union vulnerable one should see that systemic features of a monetary union cannot be ignored when trying to predict the long-run efficacy of the European Monetary Fund. Moral hazard thinking means strict punishment and severe austerity packages to those experiencing increasing debt, which does not contribute to restoring the balance. In addition, member states can be forced into default by financial markets as described above. The recent crisis emphasized some features of the monetary union that may

call into question whether there is any governance structure that can deal with them. The governance that is supposed to govern it from 2013 on will encounter these systemic properties, which may well remain imminent for a while. Long-term stability, however, would require ceasing them through a transition.

CONCLUSION

The design of the European Monetary Union excludes any automatic solidarity (insurance) mechanism (i.e. automatically organized money transfers to countries experiencing excessive debt accumulation) that can work properly in a federal state with automatic redistribution from the centralized budget to the deficit regions. The monetary union should be made *sustainable* through a transition to a *political union*, though member states show little willingness to do so. Some steps have already been taken in the direction of a union where it is not the severity of the punishment that really matters.

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