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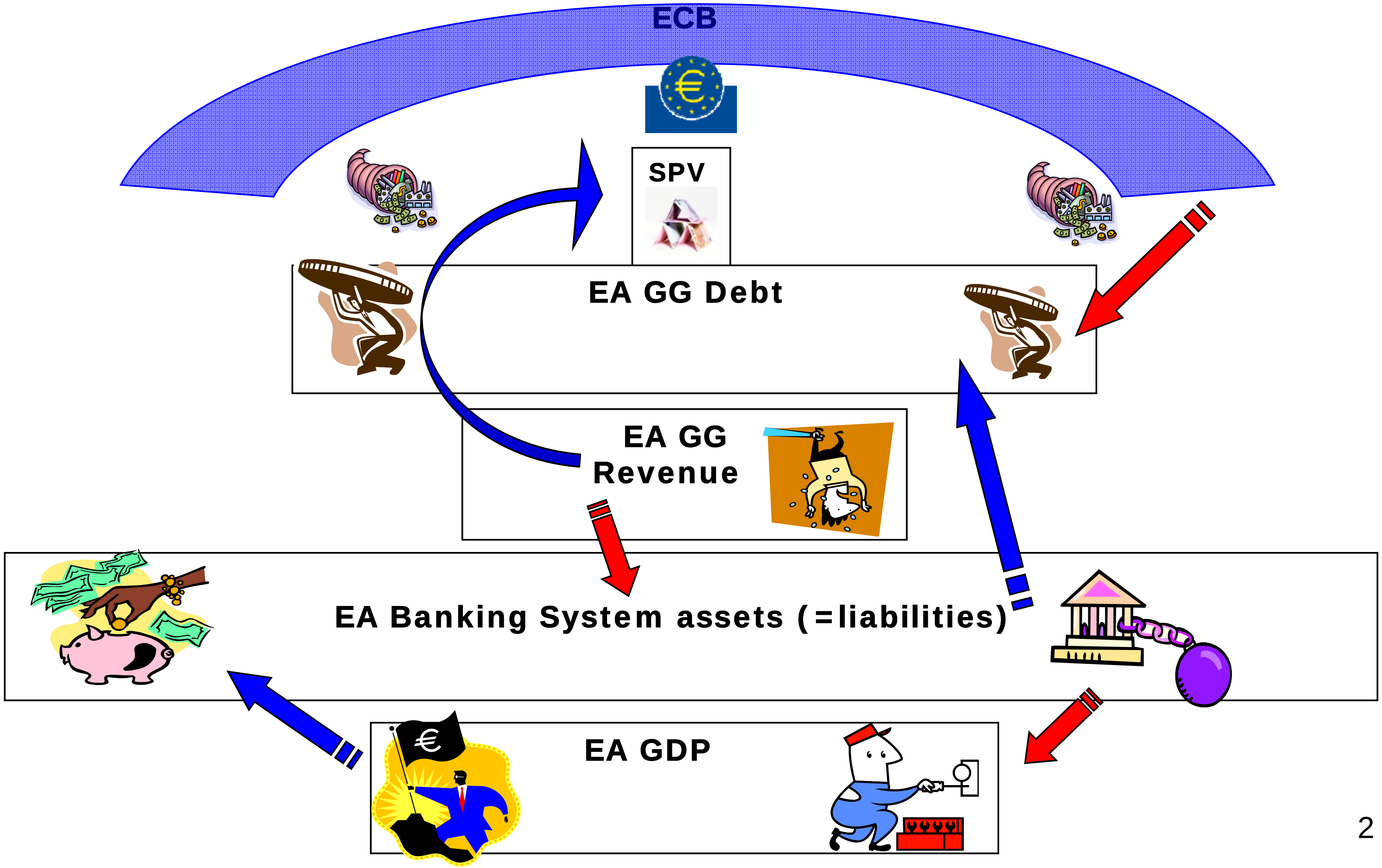
*Reinforcing economic governance in EMU: the case for a European Monetary Fund**

Ansgar Belke, DIW Berlin &
University of Duisburg-Essen

* Proposal from February 2010 revised in light of recent events and new contributions from the German MoF and ECB

The pyramid: multiple-stage bailout



EA crisis management framework: consequences & institutional follow-ups

- The current instruments in the EU dealing with debt and liquidity crises include among others the
- … European Financial Stability Facility (EFSF) and the …
- … European Financial Stabilisation Mechanism (EFSM).
- Both are temporary in nature (3 years).

EA crisis management framework: consequences & institutional follow-ups

- Efficient future crisis management framework: what follows after the EFSF and the EFSM expire in 3 years time?
- Political and economic medium- to long-term consequences?
- What needs to be done using this window of opportunity of the coming 3 years? Which institutions need to be formalized, into what format, in order to achieve coherent whole structure?

EA crisis management framework: consequences & institutional follow-ups

- Alternatives as regards the on-going debate on establishing permanent instruments to support the stability of the euro?
- Enhancement of effectiveness of SGP combined with “European semester” and a macroeconomic surveillance and crisis mechanism.
- Fiscal limits hard-coded into each country’s legislation as automatic, binding and unchangeable rules.
- European Monetary Fund as preferred solution.

European Monetary (Stability) Fund: key goals

1) Pre-empt the end game: **Recognize sovereign default as "ultima ratio" for a country in financial distress**

2) Limit moral hazard of debtors and creditors by **charging the former for excessive deficits and debt** and **imposing haircuts on the latter for imprudent lending**

Key principles

- Allow sovereign default at minimal cost in terms of <u>systemic</u> stability and public expense.
- EMF puts <u>floor</u> under market price of debt in default through guarantees and/or debt exchange.
- Floor contains <u>contagion</u> as downside for debt of other countries is also limited
- Haircuts: nominal value of debt after haircut = 60% of GDP (of defaulting country).
- GDP warrants align interests of creditors / debtors.
- EMF sole/principal creditor of defaulting country (directly through exchange or indirectly through guarantee) => political leverage of EU framework.

Stage 1 in debt workout: guarantees

Typical situation: country in trouble, lost market access and financial markets area wide in turmoil because size of losses uncertain.

- EMF agrees with the country on adjustment program and provides adjustment funding.
- EMF puts floor on value of debt by guaranteeing x% of payment obligations (with x% of debt = 60% of GDP).
- As part of an EMF-led adjustment program country negotiates restructuring with private creditors – GDP warrants are key element.
- Creditors whose claims are due during the adjustment program get same treatment.

Incentives for a stage 1 workout

- Guarantee prevents price undershoot of debt in default and hence potentially fatal mark-downs in trading book of creditors.
- **Country** negotiates in good faith with creditors on re-structuring as this paves the way for adjustment funding.
- **Creditors** negotiate in good faith with the country as they can expect to raise the recovery rate above the guarantee rate.
- GDP warrants best way to align incentives?

Stage 2: debt exchange

- If adjustment is unsuccessful, EMF becomes the sole creditor of the insolvent country through (mandatory) debt exchange.
- EMF imposes further conditionality (limits on new borrowing) on the insolvent country so as to assure that the country can repay the EMF.
- Breach of the conditions and/or default on EMF means breach of EU Treaty obligations => leaving **€** and ultimately (benefits of) EU

Disincentives for move to stage 2

- Longer-term loss of access to capital market
- Reduced access for the banking sector to ECB funds as government bonds no longer eligible as collateral
- Loss of political sovereignty
- Potentially exit from EMU and EU

EMF = EFSF + ECB?

- EFSF now exists (without Treaty change), but only for sovereign default prevention
- ECB is engaged in “debt exchange” in “dysfunctional” bond markets
- => redeployment of 440 billion Fund would be more than enough for a start-up funding of the EMF and take the ECB out of the business of lender of last resort to EMU sovereigns

EMF funding in future = automatic 'sanctions'

- Extra levy on countries that breach Maastricht criteria:
  - X % of excess debt defined as actual debt (% GDP) – 60%; X < 1?
  - Y % of excess deficit defined as actual deficit (% GDP) – 3%; Y > 1?

Professional staff and independence

- Commission/Euro Group failed to present a proper adjustment programme.
- Staff of EMF would be independent and make assessment free of political imperatives.
- New institution or special, shielded, part of Commission?
- Failures of the pre-WWII Gold Standard led to the IMF. Analogue is EMU crisis leading to EMF.

EMF versus IMF

- “Virtual EMF” could be carved out of European Department of IMF.
- Incentive for unified euro area representation within IMF?
- Natural corollary would be that EFSF would then represent euro area interests inside IMF.

EMF versus IMF

- Funding next intra-eurozone rescue will be rather cumbersome and costly, financial markets distrust complicated structures like the one set up to finance EFSF.
- Suggests golden opportunity for Europe to make a virtue of necessity by pooling its access to much-cheaper IMF funding.
- If IRE needed emergency support, much cheaper and quicker if other EA countries simply agreed together to lend their IMF quotas to IRE, which could then quickly obtain large IMF loan.

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EMF versus IMF

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Thinking ahead for Europe

- Creditor countries (Germany) would also gain, would not need to extend vast sums in guarantees to the EFSF while still safeguarding their interests within EFSF's existing structure.
- All eurozone members, then, have an interest in concentrating in smaller number of constituencies, with EFSF representing their collective interests within IMF.

The ECB's crisis management institution (CMI)

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Thinking ahead for Europe

- Key differences

1. Sovereign default not an option,
2. Financial support at penalty rates.

- Purchases of debt in 'dysfunctional' markets at "market" prices? Not true market prices if CMI/ECB are buyers of last resort even if bonds bought at less than at par.

Problems of the ECB's suggestion

- Without default option, debt exchange likely to occur at prices very favourable for creditors and ECB will remain buyer of last resort.
- Unclear what happens when country defaults on claims held by the CMI.
- Spend political capital on elaborate framework for 'economic governance' or reinforce discipline by making failure possible?

Contagion

- Reducing contagion is key for financial market stability.
- Existence of EMF would have reduced potential for contagion: investors would have known that there would not have been any losses on Spain.
- EMF could also engage in preventive action if its prior analysis has shown weak policies.

Thank you!

“A liquidity problem postponed is a problem solved but a solvency problem postponed is a problem made intractable.“

Using the ECB to prop up troubled countries will only magnify the problem over time.