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How Europe's Crisis Resolution Mechanism Created a Crisis

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The euro area's attempts to create a permanent crisis resolution mechanism have led to significant spread widening in the periphery. While the market reaction may be overdone, a quick resolution to this problem is unlikely, suggesting that spreads could remain volatile.

During the first half of the year, financial markets were transfixed by Europe's sovereign-debt crisis. Then investors shifted their concerns to the strength and durability of the US recovery and the merits of additional quantitative easing. Now, the focus is back on Europe, where several factors have combined to push peripheral spreads wider **(Display 1)**.

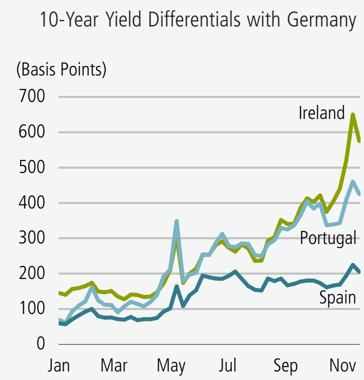
There are two main reasons for spread widening. First, the adjustment process in some countries has been disappointing. While Spain has made a good start at reducing its budget deficit without crushing its economy, and Greece's austerity program is still broadly on track, progress in Ireland and Portugal has been poor. In Ireland, the big problem has been the catastrophic impact of bank recapitalizations on the public sector balance sheet, and the resultant need to inflict even more pain on a weak economy. In Portugal, confidence has been undermined by the apparent failure to reduce the budget deficit despite better-than-expected economic growth.

The second factor, and the one that has led to rapid spread widening, has been the decision to create a permanent crisis resolution mechanism to replace the European Financial Stability Facility (EFSF) when it expires in 2013. In this sense, Europe has brought this crisis on itself.

The crisis resolution mechanism is being championed by Germany—supported by France—where it is seen as an important step towards avoiding any current or future constitutional challenges to the provision of financial support to other euro-area countries. It also implicitly recognizes that the current institutional setup in the euro area, particularly the Stability Pact, has failed to prevent the emergence of large-scale fiscal imbalances.

Ultimately, Europe's leaders need market pressure to help them impose fiscal discipline. But for this to work, it must be possible for a euro-area country to default. Hence, the idea of a crisis resolution mechanism that would provide a permanent support facility for financially stricken euro-area countries. This would be along the lines of the recent Greek package, but with one crucial difference: private sector creditors would be expected to contribute, possibly via an "orderly" default, should the adjustment program fail.

Display 1
Peripheral Spreads Widen Again



As of 11 November 2010
Source: Bloomberg

The idea that a euro-area country might be allowed to default should not come as a surprise to most investors—it is implicit, for example, in the price of Greek government debt. Nonetheless, these developments have spooked markets. One of the biggest problems is uncertainty surrounding the workings of the crisis resolution mechanism itself. While the German Finance Minister, Wolfgang Schäuble, initially talked about possible haircuts for bond holders, a more recent statement from European finance ministers, including Mr. Schäuble, focused on less painful approaches to burden-sharing.

Where Europe's leaders have done a particularly bad job, is in failing to explain how changes to the euro area's institutional framework aimed at preventing future crises will apply to countries currently implementing adjustment programs. Finance ministers have stressed that the new provisions—whatever form they eventually take—will not apply to Greece or the EFSF, that they will not come into force until the middle of 2013 and that the rules will only apply to new debt and not to existing debt. Unfortunately, confusion is such that this has done little to dispel the market's concerns.

Past experience of the European Union tells us one thing: that the negotiations relating to the crisis resolution mechanism will be long and tortuous. Moreover, given the practical difficulties involved and the scope for disagreement between euro-area governments, it is quite possible that the mechanism will eventually be shelved in favor of an alternative approach. Political uncertainty of this nature is, of course, a recipe for volatility.

There are two options that might restore calm. One is for countries like Ireland and Portugal to enter the EFSF without further delay. For Ireland, in particular, this would make a lot of sense. In December, the Irish government will provide details of a front-loaded austerity package worth €15 billion, or 9.5% of GDP, between 2011 and 2014. This comes on top of the huge tightening that has already taken place and would surely be sufficient to satisfy the conditionality required to access the EFSF's subsidized financing. The problem is that Ireland has no immediate need to access markets and may prefer to go it alone, in the hope that a radical budget will satisfy investors. We are not so optimistic.

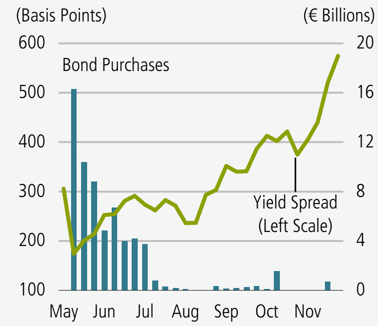
The alternative is the European Central Bank (ECB). In the second week of May, the ECB bought €16 billion of peripheral euro-area bonds and the spread between Irish and German 10-year bond yields quickly narrowed from 300 to 160 basis points **(Display 2)**. Some observers have argued that the ECB's reluctance to make similar purchases now, although spreads are considerably wider, reflects its displeasure with the plans for a crisis resolution mechanism. In our view, though, it is far more likely to reflect a deep philosophical aversion to bond purchases, together with its belief that countries that are unable to access markets should use a facility, the EFSF, that was specifically created for this purpose.

Of course, there are limits to how long the ECB can sit on the sidelines, especially if the crisis spreads to other countries and becomes systemic. But the key point is that the ECB is still resistant to the large-scale bond purchases that many feel would put an end to the crisis.

Display 2

ECB Still on the Sidelines

ECB Weekly Bond Purchases and Spread Between Irish and German 10-Year Bond Yields



As of November 11, 2010
Source: Bloomberg and Haver Analytics

Perhaps the only positive aspect at the moment is that the crisis has not yet spread, in a meaningful way, to other credit markets. There are good reasons for this, particularly the existence of the EFSF, which was not operational earlier in the year but is now providing an important safety net for the periphery. But there are few grounds for complacency. The longer the crisis continues, the bigger the risk that it could eventually spread to systemically important countries like Spain. In trying to create a crisis resolution mechanism for the periphery, Europe's leaders need to be careful that they do not precipitate an even wider crisis. ■