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| August 2011: The euro crisis reaches the core[Daniel Gros](http://www.voxeu.org/index.php?q=node/69)11 August 2011, VOX.EU*Investors are anticipating the unravelling of the 21 July 2011 “solution” and a breakdown of the interbank-market that would throw the economy into an “immediate recession” like the one experienced after the Lehman bankruptcy. This column argues that this will happen without quick and bold action. The EFSF can’t work as designed but if it were registered as a bank – which would give it access to unlimited ECB re-financing – governments could stop the generalised breakdown of confidence while leaving the management of public debt in the hand of the finance ministers.*Canaries were kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, wise miners knew that it was time to gear up the emergency procedures.Greece, as it turns out, was the Eurozone’s canary. The canary was resuscitated and a small rescue mechanism was set up to revive a further canary or two – but beyond this the warning was ignored. The miners kept on working. They convinced themselves that this was the canary’s problem.Greece wasn’t a special caseThe problems of Greece should not have been interpreted as a special case. They should have been viewed as the first manifestation of a general problem:* As a sign that the Global Crisis was spreading to public debt;
* As a sign that capital markets would no longer refinance excessive levels of public debt, especially in the Eurozone members who could no longer rely on central bank support.

This has become particularly clear after the July 2011 European Council – the meeting that was supposed to end the crisis by settling the Greek case with a mixture of lower interest rates and some private sector rescheduling and restructuring.The Greek public might not appreciate it, but it has received a preferential treatment from the EU. With the decisions taken at the July European Council, Greece will essentially have all its financing needs for the next decade arranged and is assured of paying less than 4 % on the new debt it is incurring. The two other countries with a programme, Ireland and Portugal, will have similarly low interest rates and long-term loans, but they are still expected to face the test of the markets in a few years.The debt fears reach the coreBut while Greece, Ireland, and Portugal got lower rates for their official long-term financing, Spain and Italy experienced a surge in their borrowing costs. They are paying close to 6% for ten-year money.It is clear that these countries cannot be expected to provide billions of euros in credits to Greece at 3.5% when they are paying themselves so much more. Europe’s leaders wanted to be generous to Greece, but the supply of cheap funds is limited. Not everybody can be served this way.The EFSF was designed for a peripheral crisisThis applies in particular to the Eurozone’s rescue fund, the European Financial Stability Fund (EFSF). This will simply not have enough funds to undertake the massive bond purchases now required to stabilize markets. It was sized to provide the financing promised to Greece, Ireland, and Portugal.Moreover the structure of the EFSF makes it vulnerable to a domino chain.* The rules of the EFSF imply that countries that need financing themselves or face high borrowing costs ‘step out’, i.e. no longer provide guarantees for the EFSF.
* If the borrowing costs of Italy and Spain stay at crisis levels, or if these two countries need to bail out themselves, only the core Eurozone members would remain to back the EFSF.

At this point, the debt burden on the core would become unbearable.Dangers of applying the periphery solution to the coreImportantly, the larger is the EFSF, the faster the dominos fall. The position of the French government – that the EFSF should be increased – does not make sense even from a narrow French point of view.* Financial markets have realized this and are thus driving up borrowing costs for France – the core country most in danger of losing its AAA rating.
* If France has to ‘step out’ of the EFSF, Germany (and some of its smaller neighbours) would have to carrying the whole burden.

This would be too much even for Germany – the Italian government debt alone is equivalent to the entire German GDP.How this drives the marketsThe situation is so critical because this domino effect has started to operate.* Financial markets do not wait for country after country to be downgraded.
* Investors anticipate the endgame – the unravelling of the entire EFSF/ESM structure.
* As EFSF was Eurozone leaders’ central response to the debt problem, its demise would leave the Eurozone with a big problem and no solution.

The bank-government-debt snareAs usual, banks are the weakest link and are subject to another domino effect.* Many banks hold large amounts of Eurozone government debt;
* Their credit rating can never be above that of their own sovereign.
* Anyone expecting a country’s downgrade should also sell the shares of its banks.

This, in turn, increases the cost of capital for the vulnerable banks making them more vulnerable.* Other banks – who see the falling bank share prices and widening credit-default spreads – react by refusing to provide the vulnerable banks with interbank liquidity.
* This breakdown in the interbank market, in turn, leads to a breakdown of the credit circuit.

This is what lead to the “immediate recession” experienced after the Lehman bankruptcy showed.These days it seems that the equity markets are anticipating a doomsday scenario with the economy going abruptly into recession as the interbank market breaks down under the anticipation of further public debt problems. Unfortunately this anticipation will be realized unless the breakdown of the interbank market is addressed very soon.What needs to be done At this point the Eurozone needs a massive infusion of liquidity. Given that the cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size. However, the EFSF could simply be registered as a bank and could then have access to unlimited re-financing by the ECB, which is the only institution which can provide the required liquidity quickly and in convincing quantity.This solution would have the advantage that it leaves the management of public debt problems in the hand of the finance ministries, but it provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence and liquidity. This is exactly when a lender of last resort is most needed.It would of course be much better if the ECB did not have to ‘bail out’ the European rescue mechanism, but in this case one has to choose between two evils. Even a massive increase in the ECB’s balance sheet (which if the US experience is any guide will not lead to inflation) constitutes a lesser evil compared to a breakdown of the Eurozone financial system. |