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## Three Steps to Survival for Euro Zone

Three steps are needed to rescue the euro, and possibly the European Union as a whole, from quickly collapsing in a wave of disorderly sovereign defaults and bank failures.

First, the size of the liquidity facilities providing temporary financial support to vulnerable nations must be increased to €2000 billion (\$2644 billion), of which at least half should be funded immediately. The current liquidity facilities stand at €860 billion. But because of the desire to maintain a triple-A credit rating for the largest component, the €440 billion European Financial Stability Facility (EFSF), the amount actually available to lend is only between €560 billion and €610 billion.



European Pressphoto Agency

The euro symbol outside European Central Bank headquarters in Frankfurt.

To this one can add the €67 billion worth of outright purchases (thus far) by the European Central Bank of euro-zone periphery sovereign debt. But even with that the total available is only between €727 billion and €777 billion.

That would do nicely to tide over Greece, Ireland and Portugal till mid-2013. Then the existing facilities expire and will be replaced by a permanent mechanism for the resolution of crises, designed to permit the (more) orderly restructuring of both old and new sovereign debt, through maturity extensions and haircuts for the creditors. However, it is probably not enough to fully fund the potential requirements of a troubled Spanish economy. It also falls well short of what would be needed to fund the countries like Italy, Belgium and France, should they be frozen out of the markets by a self-reinforcing and self-fulfilling wave of rising risk aversion and panic—and it certainly is not enough to deter such attacks.

Members of the euro, and even the EU as a whole, cannot in practice come up with an immediate €1000 billion. The International Monetary Fund is also not allowed to take part in any pre-funding exercise. That leaves just two sources of possible funds. The first is non-EU sovereign wealth funds. The second is the ECB. And given the first option is likely to be politically unattractive, that only leaves the ECB.

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In principle, the ECB could provide €1000 billion (or even the entire €2000 billion) directly to the countries that need them, by expanding the scope of its sovereign-debt purchases on secondary markets. This need not involve any increase in the monetary base. The ECB could instead expand its non-monetary liabilities, including term deposits, or by issuing ECB bills or bonds.

This direct approach, however, is unlikely to appeal to the ECB. Instead, it could provide indirect support, either by lending to the EFSF or by purchasing securities issued by the EFSF directly, or in the secondary markets. The EFSF is a private entity (a limited liability company incorporated in Luxembourg). But it could be turned into a bank, making it an eligible counterparty to the ECB's operations, as European Investment Bank (EIB) already is. Any debt sold by the EFSF to the ECB, or any loans provided by the ECB to the EFSF, could then be guaranteed by euro member states—they would be either E-bonds or E-loans.

Yet simply creating more liquidity will not be enough to save Europe. The Irish and Spanish sovereign-debt crisis is also a crisis of fiscal unsustainability and bank insolvency. Major structural and fiscal reforms are required in all fiscally strained countries except Ireland, where fiscal reforms suffice.

Any outcome that is fair and avoids moral hazard must therefore meet a second condition. Before a cent of taxpayers' money supports systemically important banks, the last unsecured creditor must have given his all, either through haircuts or the conversion of debt into equity.

At the moment the euro zone does not have a special insolvency regime that permits banks collectively to continue their systemically important functions while restructuring the balance sheets. The American resolution regime model for banks should be adopted quickly, preferably at the EU level, to cope with euro-zone and EU-wide cross-border banks.

Finally, a new mechanism is needed for the orderly resolution of sovereign debt defaults. Burden sharing in the correction of an unsustainable fiscal

position should see creditors share burdens, as well as taxpayers and the beneficiaries of government programs. Fairness and efficiency both point in the same direction here, although a variety of approaches can be used. These include statutory approaches, for instance a new IMF-style sovereign debt restructuring mechanism. Contractual approaches involving collective action clauses, and other market-based approaches, could also be used—including deeply discounted "voluntary" exchanges of sovereign debt for new instruments.

The result of these steps would see interest rates rise and access to market funding impaired for euro-zone banks and sovereigns when bank or sovereign debt restructuring with private burden sharing is anticipated by the markets, but not yet implemented.


This argues for the earliest possible restructuring of both bank debt and sovereign debt, and for the aggressive use of the newly enlarged liquidity facilities, including potentially large-scale financial support to prevent fundamentally solvent banks and sovereigns being tripped into unnecessary default by lack of market access.

Without such policy actions the euro, and possibly the EU, may not survive much beyond 2011. The political cement holding them together may erode should there be disorderly and, in part, unwarranted sovereign defaults.

The solutions are technically simple and politically difficult. This is apparent from the spectacle of the ECB and the euro-zone fiscal authorities engaging in a game of "chicken" about who will pick up the tab for the financial rescues.

Let's hope our leaders are up to the job.

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