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## The debt crisis in the Eurozone : A critical review of potential solutions

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# The debt crisis in the Eurozone. A critical review of potential solutions

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Klaudia Zielińska<sup>1</sup>

## Introduction

The worsening economic condition of the Eurozone was clearly underestimated by the European nations, which was reflected in the inability to make the urgent decisions. By the time the gravity of the situation was recognized, the Greek economy nearly collapsed and the governments of Portugal, Ireland, Italy and Spain were struggling to avoid losing liquidity. Other countries of the European Union, contaminated with the poor condition of their neighbors, were reluctant to help them. Consecutive meetings of the EU states were unable to find a solution to the debt crisis and this lack of cooperation has caused the public opinion to think, that the existence of the common currency as well as the whole European Union may be threatened. Even though this scenario is not probable, serious lacks in the EU regulations have been recognized and no-one is denying the need of structural changes even in the most fundamental aspects of the Union.

The easiest solution to the debt crisis would be forcing the ECB to buy out the “toxic” debt of the Member States having financial trouble. However, creating such a powerful lender of last resort would lead to serious moral hazard problems and probably end up in a hyperinflation in the Eurozone in the future. Thus, the ECB has both the obligation and right to refuse these kind of demands of the EMU Members and focus on limiting the inflation which is its main goal.

The uncovered weakness of the Eurozone has given European nations a signal, that if they want to face the worlds’ economic problems effectively, they need close cooperation. Discussions on solving the debt problems of the EMU members are getting more intense and there are several proposals, that need to be taken into account while finding the best way to heal the economy of The Old Continent.

## The European Financial Stabilization Mechanism (EFSM)

The European Financial Stabilization Mechanism has been established as a temporary solution for fighting back the debt crisis in the EU countries. The Member States have granted the European Commission the ability to loan up to 60 billion euro (Europa, 2010) if an EU

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country falls into, or is threatened by serious financial difficulties. The assistance may take a form of a loan or a credit line, that is entitling the Member to borrow money up to a certain limit.

Receiving financial support by an EU country in trouble is preceded by a procedure, during which the country concerned has to submit a request including the estimated financial needs, as well as a financial programme it obliges to enforce to regain economic stabilization. If the request is found to be justified by the Commission, the request goes to the Council and is passed by a qualified majority of votes. If the financial assistance is granted, the Council describes the detailed timetable of the loan as well as the conditions on which this help is granted. So far, the EFSM has been activated for Portugal and Ireland for a total of 48,5 billion euro (EC Europa, 2010).

## The European Financial Stability Facility (EFSF)

The European Financial Stability Facility was established in May 2010, by all European Union Members in accordance with the project of the Economic and Financial Affairs Council. This instrument was developed to combat the deepening debt crisis in the Union and the main goal of this facility is financial help for those EU countries, which have problems with national debt. The tools, through which the EFSF may help the EU members, are not only financial loans, but also interventions on the primary and secondary debt markets. An intervention on the secondary market may only occur in case of emergency, once the ECB recognizes that the financial stability of a market is threatened. The EFSF may also perform recapitalizations for the financial institutions through loaning money to the government (EFSF Europa, 2012).

To finance its operations, The European Financial Stability Facility has been granted the right to issue bonds and other debt instruments. The bonds are guaranteed by all of the Member States up to a sum of 780 billion euro (EFSF Europa, 2012) and were given the highest rating by the largest credit rating agencies. The EFSF is entitled to loan up to a total of 440 billion euro (EFSF Europa, 2012) to the countries having trouble with financing their debt. After the bailout of Ireland and Portugal, 250 billion euro (EFSF Europa, 2012) still remains at the Facilities' disposal, to secure the liquidity of the Eurozone.

The financial stability of the EMU is not only guaranteed by the EFSF, but also by the IMF and the European Financial Stabilization Mechanism for a total of 750 billion euro (EFSF Europa, 2012) lending capacity. It has to be noted though, that a country does not simply receive help once it falls into trouble – the EFSF will be able to loan the money, once the Member State negotiates the terms of an adjustment programme with the European Commission and the IMF and the programme is accepted by the Eurozone. A request can only be made if a country is unable to borrow money on the market without offering exceptionally high interest rates.

## European Stability Mechanism (ESM)

Temporary solutions forced by the tough economic condition of the EU states will eventually be replaced by a permanent institution in June 2013. The European Stability Mechanism will be created as an intergovernmental institution with a lending capacity

of 500 billion euro (ECB Monthly Bulletin, 2011). Receiving financial assistance from the ESM will require fulfilling several conditions, similar to those put forward by the EFSF and EFSM. The ESM will grant its help in form of a loan on a certain interest rate, depending on the financing costs of the ESM plus a 200 points charge (ECB Monthly Bulletin, 2011). The charge will be bigger for any amount which remains unpaid after three years. The ESM was also granted the ability to issue bonds to finance their operations and was given the highest credit rating. The capital of this permanent institution will consist of contributions from all the Member States in amounts according to their share in the ECBs' capital key within 5 years starting from July 2013. However, countries with a relatively low GDP will be able to prolong this time up to 12 years from the moment the country joins the Eurozone or the ESM is established. It should also be noted, that this way of paying in the contributions will delay achieving full strength by this mechanism. Countries outside the Eurozone will be able to participate in the ESMs' assistance by granting bilateral loans.

Creation of a permanent institution handling critical financial situation was a necessity recognized during the existing debt crisis. Existence of a powerful institution that can help the Member States should increase the credibility of their debt instruments. The only weakness of the following solution is the delay in gathering its capital, causing it to start operating with only 16 billion euro lending capacity (Gostyńska A., Tokarski P., *Stan prac nad tworzeniem Europejskiego Mechanizmu Stabilności*, 2011 ), which can weaken its performance in the first few years.

## Packet of six laws „sixpack“

Packet of six laws was designed to reinforce the Stability and Growth Pact and improve the coordination of management in the Eurozone. The experience of Greece, Ireland and Portugal has revealed low efficiency in the enforcement of the rules established in the Pact.

Packet of six laws, which were presented by European Commission, consists of five ordinance and one directive, which inter alia cover changes in Stability and Growth Pact or have an influence on the way in which Euros' countries lead their economies. The directive included in this “sixpack” universalizes the way how the national budgets will be created and controlled, by settling the methods of budget forecasting, accounting methods as well as gathering the statistics.

The work began in 2010 and negotiation lasted until September 2011, when The European Parliament accepted the package. This “sixpack” was established by a cooperation of all the EUs' institutions: The European Parliament, European Commission and European Council. Primitively EU wanted to enact the packet before the summer of 2010, but there was a conflict between The European Council and European countries. It concerned mainly the automatism of punishing the Member States, which have problems with financial discipline.

After discussing the merits of this solution, the “sixpack” has come to life. First of all, European Commission received new tools to influence the authorities of the European countries, by issuing recommendations on budgetary discipline and force instant eradication of imbalances in their economies, if their condition could threaten the whole EU economic status. What is more, this law improved cooperation between European organs and forced national authorities to respect jointly developed policies

and positions. European Commission conducted a more detailed analysis of the national expenses, increase of which will only be possible in countries in which GDP is on the increase. If any Member State decides to do otherwise, the European Institutions will be able to monitor the situation and even set financial sanctions.

European institutions will now be able to operate in situations, when EU Members' public debt exceeds 60% GDP even if the budgetary deficit does not exceed 3% GDP (Miller E., „*Sześciopak*” przyjęty w Parlamencie Europejskim, 2012). Nowadays, Italy and Belgium are in this kind of a situation. From now on, countries in that condition will have to decrease their debt by 1/20 in three years (Miller E., „*Sześciopak*” przyjęty w Parlamencie Europejskim, 2012). If they do not apply these rules or they do not solve this situation, an excessive debt procedure will be initiated for those countries, which means that European Committee will give instructions with a limited time for taking the necessary actions. Of course if countries will not apply these orders, fines will be imposed on them. EMU Members will also be obliged to place a deposit of 0,2% GDP (Miller E., „*Sześciopak*” przyjęty w Parlamencie Europejskim, 2012), which they can lose if they do not hold on to the settled boundaries.

The outcomes of enforcing the reforms included in the “sixpack” are yet to be revealed, but many politicians already try to describe the consequences for the Eurozone. Corien Wortmann-Kool, one of member of European Parliament, said that it has given the markets a signal that the EU wants to defend euro (PolskaTimes, 2011). Jerzy Buzek, head of European Parliament, stated that this reform will help avoiding a crisis in the future (PolskaTimes, 2011). Of course there are many voices of criticism and most of them consider administration of the European economy and cost-cutting policy to be inappropriate.

## Common debt as a solution to the problems of the Eurozone

Once the reliability of the economies of the Eurozone has been shattered, the possibility of issuing bonds of the euro area as a whole became very tempting. The matter, however, is very complex and there are many issues that need to be taken care of before issuing bonds of the European Union as a whole becomes possible.

After introducing the European Monetary Union, the spread between interest rates on the bonds of the Member States began narrowing down, though they never became perfect substitutes. The reason for that situation is that the risk on the bonds of each member state is different either due to the credit risk level, or the liquidity risk. The credit risk is obviously connected with the financial condition of a country issuing bonds and the liquidity risk reflects how easily these instruments can be bought or sold on the market. Hence, a developing economy with a shallow bond market will have to pay more to the investors, than a strong country with a developed market. It is therefore obvious, that the ability to issue low-risk and highly liquid bonds would allow the members, who have to pay high yields to the investors, to manage their debt more easily.

Bonds of the countries inside the EMU are highly correlated and that should not come as a surprise to anyone – these economies are strongly interdependent since close cooperation was the fundamental reason to create a common currency. The problem is that the correlation between these bonds is not stable over time and suffers some structural breakdowns. This effect is called contagion and it disrupts the accuracy of any models projecting the market responses regarding different bonds and the correlation

between them. This phenomenon can have several causes, often connected with the investors' expectations regarding crisis contamination between close economic partners, and the outcomes can be very severe. A common debt of the EMU would cause the investors to regard it as a single body and reduce the contagion effect inside the Monetary Union.

There are three theoretical models of introducing the common debt of the European Union. The first theory proposes a single instrument issued by an independent agency on behalf of the countries of the Eurozone. All of these countries would guarantee only their own share of the instrument and thus, their safety would be regarded as an average of the credit standings of the EMU participants. Moreover, because the European bonds would be issued as a single instrument, its liquidity would most probably be greater than their national debt instruments.

Second model treats the common bond as a single-type instrument, but requires guaranteeing the obligation not only by all the participating countries together, but also by each country on its own. This way the credit risk of these bonds would reflect the credit standing of the largest economies taking part in the issuance. Since every country in the EMU would have to guarantee satisfying the obligation, investors would have the right to call any of them to repay them. On the other hand, since it is the condition of the largest participating economies that would determine the credit risk of the Unions' debt, some countries could eventually have to pay more for issuing debt than when they had their national instruments. Nonetheless, there is no doubt that the liquidity of this kind of instrument would be high.

The third theory suggests creating an EU institution that would issue bonds and use the gathered funds for on-lending to the Member States. Money would be borrowed at a certain interest rate, which would reflect the financing costs and a margin, which, according to this theory, could be different for each country. When it comes to risk connected to investing in the EU debt instruments, this solution gives the strongest foundation for the common bonds, as they would be guaranteed by all of the EU members – even those outside the monetary union. The obstacle to recognize this obligation is connected with the regulations provided by the EU Treaty, as these bonds would be issued by The European Commission, The European Investment Bank or some other EU Institution. As a consequence, this type of bonds could be regarded as a practically risk-free instrument.

The creation of the common debt as a solution to the problems of the EMU remains a controversial topic. On one hand, establishing common bonds would be a great step for the integration of the union and would help coordinating the debt of the Eurozone and lower the cost of gathering money, since the liquidity and credit risk would be very low. Moreover, creating these bonds as a completely safe way of investment, would not only strengthen the position of euro as a reserve currency, but also grant the EMU countries access to sources of relatively cheap funding even during a financial crisis.

On the other hand, introducing this new instrument would mean creating a new market for them and thus it would not be in favor of integrating the EMU economies. To repeal this argument, the participating countries would have to show their commitment and prove that the common bonds will play an important role in their financing activities. Achieving that credibility would mean gradual replacement of the national bonds and their markets, as well as issuance the new instrument on a regular basis. The second argument against this solution concerns the effectiveness of the debt management – since the issuance of the bonds would have to be centralized and reflect the financial needs of all the participants, decisions regarding the level of debt in a single

country would be limited. The strongest argument, however, is that the safety of the common bonds, guaranteed by all the participating countries, would encourage hazardous behavior in the fiscal policies of the participating countries. The situation is exacerbated by the fact, that since the guarantees of the common bonds would be mutual, the no bailout clause would lose its force and credibility. A common debt would also deprive the European Institutions of some of the tools, through which they could extort strict and stable fiscal policies. The only way to solve these problems to an extent is setting the limits for the issuance of the cheap, risk free instrument and forcing the countries, which wish to exceed these limits, to issue the more expensive national debts.

When it comes to predicting which solution proposal can actually heal the condition of the European Union, there is no single answer. The legislative changes implemented by the sixpack can actually stop the growth of expenses in countries suffering from recession and thus reduce the probability of encountering trouble with gathering money on the market. Effectiveness of these laws will require firm and consequent actions of the European institutions whenever the rules of the sixpack are broken.

As far as the lending mechanisms and institutions are concerned, their ability to heal an economy in trouble can be very different for different countries and depends on both the government effectiveness and the macroeconomic situation at the time of the crisis. So far, they were not able to do more than buy some time for countries at the brink of bankruptcy and the future loans from this source will require very strict policies in order to restructure the falling economy.

## Evaluation

When it comes to negotiations regarding the solutions to the debt crisis and their implementation, it has to be noted that the largest problem does not lie in convincing the Member States to pick the right scenario. The true barrier on the way to passing the new regulations lies in the societies' unwillingness to give away any more of their countries' independence towards the European Union. Strict regulations regarding the fiscal policies of the EU countries limit their freedom of choice to an extent, which is already found to be unacceptable especially by the conservative parties of most of the nations, not to mention the sanctions which could be automatically imposed on them if they fail to follow the instructions. This is also one of the reasons why the temporary lending mechanisms did not work for the Greek economy – the society and the government were reluctant to spend the loan in a way it was meant by the European Union. The cultural and historical background of many other Member States would most probably result in a similar reaction towards serious restrictions which could guarantee proper restructuring of the economy and avoidance of moral hazard connected with receiving consecutive financial assistance. Thus, the solutions connected with financial assistance, may be effective in the short term as a way to avoid panic on the market but they will not result in sufficient structural changes in the long term.

Last but not least, the controversial solution introducing the common debt of the European Union, may be the most far – reaching instrument that might heal the European economies in the long term. On the other hand, they could also pose a serious threat connected with the moral hazard they would bring and thus, their introduction must be performed in a very strict and responsible manner. From the three ways of creating the common debt instruments, the only one that seems to be safe enough is the creation of

a separate institution, which could manage the limitation of the issuance and influence the fiscal policies of the Member States. This instrument has also several other advantages – it would introduce a risk-free instrument, which would be a valuable source of information for the markets. Furthermore, since the countries would be obliged to guarantee them by the existing regulations, it would be easier to create them, as there is no doubt that the process of reaching an agreement in this matter between the Member States will be very long.

## Conclusion

Evaluation of the solutions which have already been enforced by the Eurozone to fight the crisis is widely known – most people simply think that the European Union is unable to create a tool that would heal the debt problems of some of the Member States and prevent the others from falling into the same condition in the future. Long debates without a conclusion and no permanent solutions to be introduced on an ad hoc basis causes anxiety among the investors which makes the situation even worse. The debt crisis caused the economy of the Eurozone to suffer great losses, but it also revealed serious weaknesses of the integration process, which need to be fixed in the future. The positive outcome of this situation is that the European countries have focused on improving their cooperation rather than searching an escape from the Union.

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