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« Ensuring sustainable sovereign borrowing costs in the eurozone »

Round-table Report

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On the 24th of January 2013, Egmont – Royal Institute for International Relations organised a round-table on preventive crisis management in the eurozone. The debate focused on the possibility of combined interventions by the ESM and ECB in sovereign bond markets. The Egmont Paper 56 served as a background paper for the debate. This report evokes how participants perceived the current situation in sovereign bond markets and how they judged the effectiveness and the risks implied by the ESM/ECB scheme. Finally, beyond crisis management considerations, the solutions to the crisis were also briefly discussed.

Introduction

In the course of the eurozone sovereign debt crisis, some Member States have at times seen the interest rates on their government bonds sore to unsustainable levels. Not only Greece, Portugal and Ireland required large-scale bail-outs, but at times, other countries notably Spain and Italy saw their borrowing costs rise to threatening levels. In order to mitigate such deteriorations in the borrowing capacity of eurozone countries, an 'ex-ante', preventive, approach gradually completed the formal 'ex-post' bail-out capacity of the rescue funds, the EFSF and ESM.

This "ex-ante mechanism" basically consists of two pillars. The first pillar is provided by credit lines made available under the ESM allowing for primary market interventions. The second pillar consists in the Outright Monetary Transactions (OMT) made by the ECB. This combination stems from the ECB having made its secondary market interventions conditional on a eurozone country having obtained a credit line from the ESM[1].

[1] For a more elaborate and detailed explanation of this scheme referred hereinafter as the "ex-ante mechanism", please see Vanden Bosch X.,

Risks in eurozone sovereign bond markets: could the pressure come back?

The participants agreed that the announcement of ECB intervention through the Outright Monetary Transactions (OMT) had a profound and positive impact in the government bond markets. Much pressure was lifted by the mere announcement rather than actual activation or purchases from the ESM/ECB.

Some speakers assessed that the risk of a sudden surge in sovereign bond yields is now low. The "deterrent effect" of the OMT would have effectively decreased the probability of a future ECB intervention and stabilised financial markets. It was pointed out that the sovereign bond crisis should be understood in the framework of a typical financial crisis cycle. In this sense, the markets for financial assets have gone through a transition phase of adjustment following a period of boom and shock. Following great uncertainty in this adjustment phase, prices for government bonds are now more in line with their fundamentals, leading to a better pricing of risk. Less severe market reactions should hence now be expected as the situation has normalised.

Other participants were however questioning this optimism due to the apparent disconnection between the positive mood in sovereign bond markets and the state of the recovery. Subdued economic growth and high levels of unemployment in some eurozone countries were pointed out as a main source of concern. Social unrest could also cause a shift in mood, reviving fears of contagion in sovereign bonds markets.

The situation of Cyprus's banking sector was pointed out as the most imminent source of concern. The political risks involved in its rescue, given the involvement of Russian financial interests and the uncertain results of the forthcoming presidential elections, make unclear how assistance to Cyprus will be organised, and hence what the consequences for the eurozone would be.

The effectiveness of the ESM + ECB intervention scheme

Several participants expressed a positive opinion regarding the robustness of the ESM/ECB scheme. They were confident that the established framework is sufficiently strong to allow for an orderly adjustment in the financial markets. This setup will enable bridge financing and will provide an efficient back-stop mechanism.

The ESM Treaty includes an emergency procedure in case the financial stability of the eurozone is at risk. In this scenario, the qualified majority voting threshold is set at 85% implying only Germany, France and Italy have sufficient voting weights to block the decision on assistance on their own. Alternatively, a small reticent country would not be able to block an urgent rescue decision.

Nevertheless, there are **reasons to question the robustness of the scheme**. In the case financial assistance by the ESM and ECB is needed, some speakers doubted whether the technical and political aspects would allow

"Preventing the rise of sovereign borrowing costs in the Eurozone: what can the ESM and the ECB achieve?" Egmont Paper n°56.

the mechanism be to sufficiently efficient in practice.

The scheme creates uncertainties concerning its activation and its operation. Important implications and considerations stem from conditionality requirements of the combined ESM and ECB intervention. The main questions concerned:

- The **political stigma** attached to a request of ESM credit lines. The uncertainty surrounding the conditionality was pointed out as a destabilising factor. The mechanism might not be used even when needed as the conditionality requirements make countries reluctant to request financial assistance.
- The reaction of markets when a country requests financial assistance, as **the demand could signal weakness**.
- The possible interpretation of the country's economic situation when it requests the opening of credit lines. **Whether the country's yield levels are unwarranted** when its situation is assessed by the Eurogroup. (Does the country suffer from a liquidity rather than solvency crisis?)
- The conditionality attached to the support. Eligibility criteria set in the ESM guidelines underline the flexibility allowed when granting credit lines. But **the flexibility can create uncertainty** about whether the country will ultimately be granted support.
- The effectiveness of the decision-making procedures given accountability issues (constitutional court decisions, national parliament's approval).
- Whether the financial instruments and resources at the disposal of the ESM and ECB will suffice in case a larger eurozone Member State needs financial aid. A participant considered OMT has not truly unlimited as purchases would be constrained by the volume of assets with a low maturity.
- The impact of a severe economic shock on the meeting of conditionality requirements. (Can a country still benefit from the scheme when it is most in need of financial support?)

Once intervention through the ex-ante mechanism starts, additional risks and issues involve:

- Accumulation of short term debt making the supported country more vulnerable.
- The ECB giving up some of its independence, as a shift from monetary dominance to fiscal dominance takes place.
- The ECB exit strategy being dependent on a political process.
- The political risks include social unrest and electoral problems as austerity fatigue leads to opposition against the conditionality requirements demanded in return for financial assistance.

Beyond crisis management, the need for crisis resolution

The "safety net" - the potential interventions of the ECB and ESM - results from a series of different decisions rather than from a well-thought design. As discussed by participants, it might not be "complete" enough. It was however generally agreed this set-up can only provide **a crisis management tool to give European leaders the required time to act**

and make further progress on structural solutions.

Although the debate did not specifically address the question, some of these structural solutions were evoked. However, no clear consensus emerged on the priorities and measures to implement during the time bought by the crisis management instruments.

Some insisted on the need to create a **safe European asset**. The idea of eurobonds (or other form of debt mutualisation) has however gradually receded from the EU agenda. What remains is the call from the EU Parliament to consider eurobills or a redemption fund. Instead, some saw the creation of a fiscal capacity at the EU level as a solution to "complete the EMU". Certain speakers encouraged the idea of establishing a common federal debt and accompanying federal capacity to borrow.

However, some discussants, insisted that the rebalancing of the economy - including rebalancing current account deficits - mostly lies in the hands of individual countries. Others mentioned reforms should not only consist of austerity measures. Tax cooperation and efforts to encourage investment are needed.

Most agreed the most crucial question is to solve the **financial sector crisis**. The establishment of a "Banking Union" would be an essential aspect as "bad debts" on the balance sheet of banks remain a major source of risks and impedes the recovery.

Despite the improvements made so far, participants generally agreed a **sense of complacency could hold back further required progress on reforms**. As the pressure in the financial markets has lowered, the sense of urgency has diminished. The OMT announcement would risk lifting the pressure on politicians to act. The paradox could be that some more pressure would be needed to allow for bold structural decisions to solve the crisis at the EU level. The assumption of unlimited market intervention and decreased pressure in the financial markets could furthermore result in lower pressure on eurozone countries to implement structural reforms.

The roundtable debate took place under the Chatham House Rule.

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