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FINANCIAL CRISIS, EURO PERSPECTIVES AND THE BALKANS

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ABSTRACT: After having pointed to the large-scale problems of the status quo related to the euro area financial and debt crisis we describe the current crisis management framework and assess what its consequences and institutional follow-ups are. We then look at the implications of the latter for the Balkans: do they imply trouble for the Balkan EU perspective? We also briefly sketch what needs to be done in institutional terms in order to prevent future crises. The main part of the paper is devoted to an assessment of the seminal proposal of a European Monetary Fund. We derive that it is a preferable blueprint in our context. We finally convey an outlook on different issues: first on the still open and critical issues in euro area crisis management, second on the interaction of bank and sovereign debt resolution and, finally, also on the future economic performance of the Balkans, i.e. Croatia, Macedonia joint with Turkey, with an

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eye on the post-crisis era. We point out that the latter will be closely intertwined with the problem solution capacity in the euro area.

KEYWORDS: EU governance, European Council, European Financial Stability Facility, European Monetary Fund, policy coordination, scoreboard, Stability and Growth Pact

JEL Classification: E61, E62, F55, P48

Introduction: Large-scale problems of the status quo

The scale of the current debt problem is large. For Greece, 110 billion euros have already been agreed upon. A second package is in the making. The EFSF plus EFSM (European Financial Stability Mechanism) headline amounts to a nominal value of 500 billion euro, which in reality corresponds to a sum of 255 billion euros, due to a couple of deductions. Most importantly, only those countries can act as guarantors for other states if they have a triple-A rating, i.e. the highest credit rating: Germany, France, the Netherlands, Austria, Finland and Luxembourg[2]. If the needs of Ireland and Portugal are considered to be of the same magnitude as Greece, this directly implies that the package might not necessarily be able to deal with Spain. If after Ireland also Portugal turns to the EFSF then in the end after all experience with this crisis only the ECB can prevent financial market meltdown.

The first basic problem connected with that addresses the fact that the euro area is a monetary union, but not a fiscal or even political union. This is precisely why there is no guarantee clause (note that we later on argue that Art. 125 TFEU is not a 'no bail out' clause). "No bail out" is not credible with integrated financial markets. When markets are close to meltdown creditors have little choice.

Deciding on the way of "bailing in" the private sector is the second fundamental problem. The European Council was faced on October 29, 2010, with the pioneering question whether it should agree on a permanent 'crisis resolution mechanism' demanded by markets and debtor countries in exchange of a 'bail in' mechanism as demanded by Germany. The existence of the turning point per se and its actual solution have initiated huge turmoil in the markets.

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[2] Correspondingly, the IMF would provide net credits at the amount of only 160 billion euro. In sum, analysts estimate that, hence, a total of 475 billion euro could be paid out as financial support.

Hence, details of the envisaged involvement of the private sector should be resolved quickly. Should it take place always? Should one re-design the timetable of repayments without altering the present value of the former (rescheduling) or even diminish the present value down to a level which appears to be sufficient to arrive at sustainable public finances (restructuring)? What about haircuts? Should they only be applied to new debt or should old debt also be considered?

Otherwise we might see tensions rising between the "North" and the "South" of the euro area (Belke, 2010a). On the one hand, there is the view of the German Chancellor Mrs. Merkel who interprets Art. 125 TFEU as a "no bail out clause" and argues accordingly that the monetary union cannot become a transfer union. Hence, the "North" sees a member state failure as an option. This necessitates tough conditionality and rules for orderly bankruptcy. On the other hand, Mr. Trichet - really standing for the "South"? - does not stop claiming that "we are all in the same boat". In that sense, a member state should not be left alone if it is in trouble. In the extreme, this view implies that there is neither a plan B necessary nor is there any floor to the rating of collateral foreseen at the ECB[3].

In the wake of the October 29, 2010, European Council, the tensions between the "North" and the "South" came back on the scene. The aim of policy should thus not only be to prevent failures, rather it should also prepare for it. An EMF could be based on permanent EFSF. Since the available collective action clauses are insufficient, there is the necessity of mopping up law.

It has to be mentioned that there are a couple of differences in sovereign and private defaults. Therefore, sovereign-debt crisis are more complicated to deal with, since instruments to handle the situation in an orderly way are much more limited than in the case of private debt. In the latter case, the problem can be solved by liquidating the borrower's assets and, referring to corporations, dissolving the organization (Gianviti et al., 2010, p. 19). All these considerations also have a bearing for the euro perspective of the Balkans, as later on explained in this contribution.

The remainder of the paper proceeds as follows. In section 2, we describe the current euro area crisis management framework and assess what its consequences and institutional follow-ups are. In section 3, we look at the implications of the latter for the Balkans: do they imply trouble for the Balkan EU perspective? In section 4, we briefly sketch what needs to be done in institutional terms in order to

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[3] I gratefully acknowledge comments from Daniel Gros on this issue.

prevent future crises. The main emphasis of this paper is laid on the seminal proposal of a European Monetary Fund. In section 5 we derive that it is a preferable blueprint in our context. Section 6 conveys an outlook on different issues: first on the still open and critical issues in crisis management, second on the interaction of bank and sovereign debt resolution and on the future economic performance of the Balkans, i.e. Croatia, Macedonia joint with Turkey, in the wake of the crisis.

Euro area crisis management framework: consequences and institutional follow-ups

The *current* instruments in the EU dealing with debt and liquidity crises include among others the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Both are temporary in nature (3 years). However, a long lingering question has been the one concerning the efficient *future* crisis management framework, i.e. what follows after the EFSF and the EFSM expire in 3 years time? What are the respective political and economic medium- to long-term consequences? What needs to be done using this *window of opportunity* of the coming 3 years? Which institutions need to be formalized, into what format, in order to achieve coherent whole structure (Belke, 2010)?

Which have been the alternatives as regards the on-going debate on establishing permanent instruments to support the stability of the euro? Should we confine ourselves to the *enhancement of the effectiveness of Stability and Growth Pact (SGP)* in combination with a "European semester" and macroeconomic surveillance and a crisis mechanism? Or would it be better to stick to *fiscal limits to be hard-coded into each country's legislation* as automatic, binding and unchangeable rules (Annunziata, 2010, Belke, 2010). Or finally, just to anticipate the solution preferred by the author: a *European Monetary Fund*.

Seen on the whole, thus, the status quo has not been an effective solution for insolvent debtors; it merely frontloaded the day of final reckoning to some day in the future. In addition, it makes debtor countries hooked on it. Since access to the ECB's ordinary monetary policy operations is the cheapest way of refinancing, the distressed banks will even steadily increase their dependence from this source (Gros, 2010a). This process will finally lead to a concentration of bad risks on the ECB balance sheet as described in detail in Belke (2010b). And even questions like "Can central banks go bankrupt?" may come on the agenda.

The ECB and the EFSF have assumed the allocation function of capital markets, since they decide in a completely discretionary manner which countries and which banks are granted access to (re-) financing at which costs. ECB lending to Greece and Ireland amounts to a *subsidy* worth more than the transfer from the EU Structural Funds. Are the inflation tax and seigniorage the final way out (Belke and Polleit, 2011)? Let us now turn to the impact the troublesome status quo and the lack of an institutional plan B in the euro area might have also on the Balkan countries.

Implications for the Balkans: trouble for the Balkan EU perspective

The Euro crisis is far from over despite – or perhaps because of – the set-up an emergency fund to protect euro area countries from going bankrupt. Economic outlook in periphery grim: profound political consequences likely, not least on EU's enlargement policy. The Balkan countries, which are currently striving to get into the EU and (until recently also) the euro area as full members, should take note[4]. German voters are no longer feeling generous which becomes obvious in the current debate about the second Greek rescue package. As a consequence of designing ever larger credit packages instead of a hard debt restructuring the public debate in Germany is turning increasingly Germano-centric and sometimes becomes even anti-EU. Chancellor Merkel was punished for standing up for Europe in 2010 regional elections. Her party, the Christian Democrats, lost to opposition in Northrhine-Westphalia which is one of Germany's key states. The developments in Germany cannot be considered to be an isolated case on the European political scene[5].

How much the Balkan countries can expect from Europe in terms of money and political support is a question with no longer any clear answer. Some analysts feel that "European solidarity is under attack across Europe" (Grgic, 2010) Today, as Greece is struggling to keep its finances above water, and the group of troubled economies becomes numerous, enlargement skeptics also in Brussels may feel slightly vindicated. Is this the end of enlargement of the euro area after Estonia's late entry as foreseen by some (Belke 2010c)? Ending European enlargement now could bring about *new instability* in the Balkans, and would probably stop the process of political and economic transformation in EU's eastern neighborhood (Grgic, 2010).

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[4]For the benefits of the EMU anchor in candidate and potential candidate countries see EU Commission (2008). For the impacts of the recent financial crisis on the Central and Eastern European countries with their strong ties and spillovers to the Balkans see ECB (2010a).

[5]Simply look at the strengthening of the National Front in France and similar tendencies in the Netherlands and Finland.

The Balkans are also suffering economically from the recent financial and economic crisis. Since credits are drying up across Europe, less and less of them are directed towards the Balkans in terms of direct bank loans and private investments. At the same time, unemployment is rising, social benefits are cut, and governments are struggling to meet their debt obligation (Darvas, 2010). If the perspective of a European future becomes unrealistic, Balkan politics does after all experience have the *potential to quickly revert to nationalism and radicalism* to draw the minds of the voters away from the economic wows facing the region. A typical question in this context runs as follows: "Why should Balkan leaders choose to pay the political price associated with difficult economic reforms when their counterparts in the EU are wrapping themselves with national flags and abandoning pan-European solutions?" (Grgic, 2010).

What needs to be done?

A *stronger framework for budgetary and macroeconomic stability* to prevent the build-up of unsustainable private debt will reduce the likelihood of future crises, but even the strongest framework will occasionally fail and the present crisis is likely to drag on for quite some time. EU thus needs a *framework for dealing with a crisis* in a member state that may *threaten the stability of the euro* and may take the rest of the euro area as a hostage. The *key* to making crisis manageable is a *strong financial system* that is able to withstand systemic shocks. (Amato et al., 2010).

A variety of *measures* should be used to strengthen market discipline (Amato et al., 2010). Intermediaries and institutional investors should be required by *supervisors* to pay adequate attention to the Commission's warnings on the sustainability of sovereign obligations of euro area members. *Rules limiting excessive credit expansion and risk-taking* by financial intermediaries will also affect their willingness to finance risky sovereign debtors. Critical is a *credible promise*, in the event that one member state becomes insolvent, *not to intervene to relieve its creditors*. This promise must be founded on *two pillars* (Amato et al., 2010).

The *first pillar* consists of *new banking rules* making it possible for any bank, including large cross-border banks, to fail and thus not reimburse fully their creditors and equity holders – with the sole exception of insured (retail) depositors. Strong incentives for bank managers and equity holders to limit risk-taking and create much more stringent market discipline also extending to sovereign borrowers. A good start would be to make it adamantly clear that

banks will have to bear the losses still hidden in their balance sheets and government deficits will not be swollen even more to bail out their creditors.

The *second pillar* which should be envisaged is a *European Monetary Fund* (EMF) – the permanent continuation of the present EFSF which has now been endorsed by the EC– endowed with sufficient capital and access to market financing to protect the euro and the Union's financial system from the fall-out of a sovereign debt crisis. Its mandate should *not include* covering *losses* of public and private *insolvencies*. The main task should be *to cushion systemic financial shocks* and keep them from turning into fully fledged runs on depository financial institutions, thus *preserving confidence*.

It could lend to the member states, with reimbursement of the loan taking priority over all outstanding debt and strong conditionality – but *never bail out their creditor banks*, as was clearly the goal with the Greek interventions last May. And it could similarly help *manage the resolution of large cross-border banks*, e.g. as suggested by the Commission by providing capital to bridge banks emerging from the liquidation, while leaving equity holders and creditors to bear full residual losses.

The European Monetary Fund: a preferable blueprint

Let me now briefly elaborate on how to interpret the EMF proposal by Gros and Mayer which incorporates many elements not included in the EU Commission package but is in strong compliance with Feio (2010) (Belke, 2010a; Gros and Mayer, 2010). *Pre-empting the end game*, i.e. recognize sovereign default as "ultima ratio" for a country in financial distress, and *limiting moral hazard of debtors and creditors* by charging the former for excessive deficits and debt and imposing haircuts on the latter for imprudent lending are among the *key goals* of a European Monetary (Stability) Fund. In this respect, the EMF proposal is in accordance with Feio (2010) ("such a mechanism should…avoid moral hazard …").

The main mechanics of an EMF

The *key principles* of the EMF are as follows. It allows sovereign default at minimal cost in terms of systemic stability and public expense. It puts a floor under the market price of debt in default through guarantees and/or debt exchange. This floor contains contagion as the downside for debt of other countries is also limited (note that Spain's public debt share at GDP amounted not more than 60 percent at the start of the debt crisis). Concerning haircuts, the nominal value of debt after the

haircut shall amount to 60% of GDP of the defaulting country. The idea is that telling markets what the haircut will be would keep the defaulted bonds tradeable in secondary markets and prevent complete market chaos. And what is the benefit to the creditors? The only alternative for a private creditor would be a much bigger haircut. Gros and Mayer (2010) think of *GDP warrants* to align the interests of creditors and debtors. Since the EMF might become the sole or at least the principal creditor of the defaulting country (directly through exchange or indirectly through guarantee) the political leverage of EU framework can be applied to discipline the "debt sinners" (Belke, 2010a; Gros and Mayer, 2010).

Stage 1 in debt workout consists of guarantees granted by the EMF. The typical situation to start from is a country in trouble which has lost its market access and financial markets which are area wide in turmoil because the size of losses is uncertain. In this case, the EMF agrees with the country on the adjustment program and provides adjustment funding. The EMF puts a floor on the value of debt by guaranteeing x% of payment obligations (with x% of debt = 60% of GDP). As a part of an EMF-led adjustment program, the country negotiates restructuring with private creditors. GDP warrants are again a key element. Creditors whose claims are due during the adjustment program get the same treatment (Belke, 2010a, Gros and Mayer, 2010).

There are strong *incentives for a stage 1 debt workout* because the guarantee prevents the price of debt from undershooting and, hence, potentially fatal mark-downs in the trading book of creditors. The debtor country negotiates in good faith with creditors on re-structuring as this paves the way for adjustment funding. The creditors negotiate in good faith with the country as they can expect to raise the recovery rate above the guarantee rate. The question here is whether GDP warrants are the best way to align incentives. These negotiations could well be accompanied by rules which should be conducive to relatively early engagement of creditors and debtors in an exchange of information and views on the current situation in order to reduce the uncertainty of the creditors (Gianviti et al., 2010, Krueger, 2002).

As *stage 2 in the debt workout*, Gros and Mayer (2010) provide for a debt exchange. If adjustment is unsuccessful, the EMF becomes the sole creditor of the insolvent country through (mandatory) debt exchange. The EMF imposes further conditionality, i.e. limits on new borrowing, on the insolvent country so as to assure that the country can repay the EMF. Any European mechanism would need to include measures to safeguard the impartiality between creditors and debtors of the debt restructuring process (Gianviti et al., 2010). Any breach of the conditions and/or the default on the EMF would mean a breach of EU Treaty obligations. Hence, leaving the euro area and ultimately dispensing with the benefits of the EU

are the dire consequence[6]. This part of the EMF proposal fulfills the demands outlined in Feio (2010) that the new mechanism should include rules for conditionality for exceptional loans and that one needs clear rules for the powers of the Fund.

An important element of the EMF procedure is represented by the *disincentives to move to stage 2* of the debt workout. This is because the latter would imply a longer-term loss of access to capital market, reduced access for the banking sector to ECB funds as government bonds would no longer be eligible as collateral, a loss of political sovereignty and a potential exit from EMU and EU. This is again in strict accordance with the position presented in Feio (2010) ("such a mechanism should … be consistent with state aid principles and the consequences of ignoring them").

The EMF could *substitute the status quo solution consisting of a combination of the EFSF plus the ECB*. The EFSF now exists (without any Treaty change!), but only for sovereign default prevention. And the ECB is engaged in "debt exchange" in "dysfunctional" bond markets. This means that the *redeployment* of the 440 billion Fund would be more than enough for a start-up funding of the EMF and, even more important, would take the ECB out of the business of lender of last resort to EMU sovereigns. In this respect, the EMF proposal closely corresponds to the position described in Feio (2010): "it shall be based on existing mechanisms".

The *EMF funding in the future is by automatic 'sanctions'*. Gros and Mayer propose an extra levy on countries that breach the Maastricht criteria: X% of excess debt defined as actual debt (% GDP) - 60% with X<1, and Y% of excess deficit defined as actual deficit (% GDP) - 3% with Y>1. This property closely corresponds to Feio: "the mechanism…should include clear rules inter alia on…membership criteria, such as fulfilling the minimum requirements for national budgetary rules/institutions…and funding" and "clear rules for…resources".

The EMF should be endowed with *professional staff and independence*. According to Gros and Mayer, the staff of the EMF should be independent and make assessments free of political imperatives. The open question is whether it should be a new institution or a special, shielded, part of Commission. Also rules for

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[6] Fahrholz and Wójcik (2010) argue that specifying conditions for leaving the EMU would work through several channels. Overall, making exit costs and procedures explicit would raise the perceived costs of a legally possible exit relative to the short-term political costs of economic adjustment. This would be a deterrent to brinkmanship, stimulate fiscal discipline and lower the scope of the inherent negative externality problem within the euro area. Haede (2010), however, takes a more critical view on this issue.

decision-making procedures as requested by Feio (2010) are not clarified up to now. Failures of the pre-WWII Gold Standard led to the IMF. An analogue is the EMU crisis which might lead to an EMF (Belke, 2010a, Gros and Mayer, 2010).

Concerning the "EMF versus IMF" dichotomy, Daniel Gros is right in arguing that a "virtual EMF" could be carved out of European Department of the IMF. Since there might be an incentive for a unified euro area representation within the IMF, a natural corollary would be that EFSF would then represent euro area interests inside the IMF (Gros, 2010b). Although they appear rather similar at first glance, there are a couple of *key differences between the EMF proposal and the ECB's crisis management institution (CMI)* worth mentioning here (on the CMI which has been proposed by the ECB without any recourse to the necessity of a treaty change see Belke, 2010): within the ECB proposal, sovereign default is not an option and financial support comes at penalty rates. An important question is whether the CMI would really conduct purchases of debt in 'dysfunctional' markets at "market" prices. A well-informed guess would be that these are not true market prices if the CMI and/or the ECB are the buyers of last resort even if the bonds are bought at less than at par (Belke, 2010a, Gros and Mayer, 2010).

There are further *problems inherent in the ECB's suggestion*. Without default option, the debt exchange likely occurs at prices which are very favourable for creditors and, in addition, the ECB will remain the buyer of last resort for the time being. Moreover, it remains unclear what happens when a country defaults on claims held by the CMI. Finally, as noted by Gianviti et al. (2010), the "ECB's request for preferred creditor status" within the CMI might prove counterproductive, since in this case private creditors would still be plagued by the risk of losing their money. Hence, the main question is whether the European Parliament and other institutions should really spend more political capital on developing an elaborate framework for 'economic governance' or whether it should focus on reinforcing discipline by making failure possible.

Reducing contagion is key for financial market stability in the euro area. The mere existence of EMF would have reduced the potential for contagion since investors would have known that there would not have been any significant losses on Spain with a debt-to-GDP ratio of not significantly more than 60 percent at the start of the debt crisis (Belke, 2010a, Gros and Mayer, 2010). Finally, the EMF could also engage in preventive action if its prior analysis has shown weak policies. This would correspond to the request of clear rules for monitoring in Feio (2010).

EMF – Legal issues

An EMF would (probably) be *compatible with the Treaty* (i.e., necessitate only small changes of it). A sovereign insolvency mechanism to which the EU Council has committed itself could represent a half-way compromise between a “complete liquidation” and infinite financing of weak countries (and banks). This mechanism has to embrace a controlled rescheduling or even a debt restructuring in order to avoid the emergence of addicted countries being on the drip in the periphery of the euro area (Gros, 2010a). An EMF, for instance, fulfills these conditions – even if one would not be forced to call it “EMF”.

Haede (2010) comes up with a quite skeptic legal evaluation of a Monetary Fund (Haede, 2010). However, it should be argued that higher payments to the EMF linked to excessive deficits are not to be considered as ‘sanctions’ and, thus, not as compatible with the Treaty, but as contributions to a mutual insurance scheme. This makes them compatible with the basic EU principle that any ‘sanction’ must be somehow related to the aim that is supposed to be achieved. Sanctions such as withdrawing voting rights or zero interest bearing deposits (which go to the EU budget) have no direct link to the aim, which is financial stability.

Problems with EMF debt workout, stage II

The fact that in the future *private creditors will take a share in the costs of a default* is believed to be the main trigger for panic spreading on the markets in the recent period. The EU heads of state have already decided that it will end up like that. In the short-run proposals shall be available *how* this will be managed in the time after mid-2013 when the current rescue package will run out. However, the second Greek rescue package negotiated these days shows how difficult it is to let creditors systematically participate in it. What is more, the uncertainty about what will happen thereafter, the fear to be asked to pay up before that date and that collective-action clauses are still in the debate are making investors extremely nervous.

What is more, financial market actors could speculate against a country as soon as the expectation manifests itself that it will utilize the crisis mechanism. Some even argue that the crisis would be even caused by these linkages. Also the banking system of the default-prone country might “collapse” since it is dependent on government guarantees. The social and political consequences of such a development are incalculable. In the end, exactly the opposite of the original intentions would be reached: speculative investors would take advantage of the current situation while many small savers suffer damage. Over the previous days

investors have already withdrawn their money from endangered countries like Ireland und Portugal (Bini Smaghi, 2010).

However, this view appears to be overly pessimistic because the available academic literature on the effects of creating a sovereign-debt resolution mechanism on bond yields tells us that the introduction of rules (with the involvement of creditors) for coping with sovereign default will corroborate the inclination of markets to differentiate between high and low quality borrowers and to evaluate loans and bonds accordingly. An insightful study in this respect is Eichengreen and Mody (2004) who examine the implications of including collective-action clauses in loan contracts for borrowing costs. For a sample of some 2,000 international bonds, they compare the spreads on bonds subject to UK governing law which typically include *collective-action clauses*, with spreads on bonds subject to US law, which do not. Contrary to the assertions of some market participants, they find that collective-action clauses in fact *reduce* the cost of borrowing for *more credit-worthy* issuers who appear to benefit from the ability to avail themselves of an orderly restructuring process. In contrast, *less credit-worthy* issuers pay *higher spreads*. They conjecture that for less credit-worthy borrowers the advantages of orderly restructuring are *offset by the moral hazard and default risk* associated with the presence of renegotiation-friendly loan provisions.

Without much ado a straightforward implication would *ceteris paribus* be for the euro area that the introduction of rules for dealing with sovereign default would reinforce market discipline and support “the goal of sustainable public finances laid down in the European Treaty, and thereby to the sustainability of the euro itself” (Gianviti et al., 2010). However, current and future research should urgently focus on the *applicability of the ceteris paribus clause*. As mentioned in section 1, there appears, for instance, to be a legal vacuum how to organize orderly and unscheduled default in the euro area (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries). Moreover, empirical results by Bradley et al. (2010) indicate that the judicial injection of uncertainty into the meaning of crucial contract terms is priced by capital market participants in a predictable way. Decisions that increase the risk of repayment by sovereigns raise the rate return sovereigns must pay in order to attract international capital. Decisions that reduce this risk, in turn, tend to lower the cost of capital that sovereigns face. At first glance, this might contradict the findings by Eichengreen and Mody (2004). However, the main question to be answered in this context is, of course, whether the introduction of rules for dealing with sovereign default enhances or lowers uncertainty about repayment.

A second argument against the (pessimistic) Bini Smaghi view might be that the new European crisis resolution mechanism could be *designed* in a way that private creditors would not have any reason to panic. For instance, the new crisis resolution mechanism could be formulated in a way that it is *not applicable to old debt but only to new credit* from mid-2013 on. Such kind of a solution would correspond to suggestions put forward by Germany's finance minister Mr. Schaeuble: as soon as a country gets into payment difficulties, an austerity and stabilization programme will be activated – just like in spring this year in the case of Greece. As a first step, the *maturity of those bonds could be prolonged* which become due within this critical phase. If this is not effective, private creditors would have to accept haircuts on their claims as a second step. In return, they would be granted guarantees on the remaining parts (both measures are also main ingredients of the EMF proposal).

Involvement of private creditor participation is, for instance, also supported by Bruegel (see Gianviti et al., 2010), the German Council of Economic Advisors (Sachverständigenrat, 2010) and in the most recent proposal of a second Greek rescue package from June 2011 by the German Finance Minister Wolfgang Schaeuble as well. Bruegel, for instance, recommends that euro area countries should be allowed to issue new bonds only if a fixed crisis resolution mechanism including an involvement of private creditors is in place.

The German Council of Economic Advisors even goes a step further. It proposes that private creditors should participate in a stabilisation programme if the EU Commission has proposed sanctions against a deficit country. This proposal refers to countries which have actively offended the rules of the SGP but not to governments which got into payment difficulties through no fault of their own, for instance, by a financial crisis. Whereas the more general line of Bruegel deserves support, the latter recommendation might go too far. It appears to be too early to involve private creditors before payment difficulties have occurred. Moreover, for all practical purposes it turns out rather difficult to distinguish whether a country got into distress through no fault or fault of their own. Seen on the whole, thus, this paper argues that private creditors should (be forced to) take into account (by an incentive structure like the EMF) that a solvency problem postponed is a problem made intractable and that it is better to make a painful break than draw out the agony.

EMF: Further caveats

The remaining caveats with respect to the EMF proposal are both related to the EMF's "trigger of debt workout stage 2" issue. Another open flank of the EMF

proposal consists of the fact that it is not clear up to now how and whether to treat countries suffering distress due to excessive private and public consumption (e.g., Greece) differently within the debt workout scheme than countries whose budgetary stance suffers from collapsing banks (e.g., Ireland). Finally, the issue of how much authority creditors like the EMF have over the future stance of the primary surplus and, hence, the extent of austerity in the first period after restructuring still remains critical. This is because the rewards to the government's taxing authority depend on the quality of institutions and the citizens' allegiance which in turn is related to sound principles of democracy (Gianviti et al., 2010, Raffer 1990). These are truly decisive questions, also addressing the proponents of an otherwise preferable EMF-type solution.

Outlook

Crisis management: open issues

After October 29 European Council the 'clash of civilizations' was renewed (Belke, 2010a). Policy should not only aim at preventing failure, but also at preparing for it. The EMF could be based on a permanent EFSF with funding not only for countries. Collective action clauses are insufficient and need mopping up law. The present policy stance of claiming seniority for official bailout financing runs the risk of triggering a vicious circle. The ever-larger resources available for bailouts could be taken as a signal that an ever-greater share of eventually losses will be shifted to long-term government bonds. This is sometimes called the „seniority conundrum": long-term bond rates would rise as a consequence (Gros, 2010c).

Since movements of bond rates are the key measure of any financial market reaction to the package, each subsequent package could lead to higher observed risk premia which would put even more euro area nations into precarious situations that would require yet more, even larger bailout packages. One could call it, thus, a vicious circle. Moreover, the large-scale buying activities of peripheral debt enacted by the ECB could end up having a similar destabilising effect if the ECB were also insisting to be treated as a senior creditor.

Obviously there are only *two ways out of this circle*: creditors are bailed in via a rescheduling, or the rescue packages are made sufficiently large to make sure that they cover the entire stock of the outstanding debt. The former option would potentially be considered a 'credit event' by ratings agencies and would thus trigger most of the negative consequences of a formal default and, hence, not very

much appreciated by the ECB. The latter way would not be compatible with the Treaty and would in any event overtax the fiscal capacity of the core countries (Gros, 2010c). Unless European policy-makers rethink their decision and still stick to the fiction that no member country can be sent into an orderly default, they have *only unpleasant options* available.

Outlook: Interaction of bank and sovereign debt resolution

The financial crisis has highlighted the issue of establishing effective bank resolution regimes in order to allow for the orderly wind-down in particular of large international financial institutions. This could contribute to reducing the challenge posed by "Systemically Important Financial Institutions" (SIFIs) to financial stability. In context of designing such a resolution framework, there is a need to decide on a burden sharing between owners, creditors (i.e. other banks whose viability may in turn be negatively affected), other stakeholders and if necessary the wider public. Moreover, following turbulent times in the government bond markets, and the opening of the credit lines of the EFSM and EFSF for Ireland, the ESM has been proposed by the Council, to be created under Art 136 TFEU.

It is expected and has been fixed in the meantime that the ESM will be a successor of the EFSF and includes three components: 1) a macroeconomic adjustment programme, 2) an intergovernmental financing instrument and 3) case by case involvement of private creditors. Although the ESM will not be of direct help in the current turbulences, its mechanism design will send a signal. In the future "haircuts" or "bail-ins" may be applied to some bond holders and debt instruments. This should ideally happen in a way that should not endanger the stability of the system and of solvent banks.

As we see it, the core points for the debate and questions of future research are: what are the similarities and differences in these potential "second order" failures triggered by the resolution of financial institutions and sovereigns? How can proposals to contain these risks be developed? What would these proposals look like? How should the ESM and the bank resolution regime be intelligently linked to each other in order to account for this circuit of debt that is currently being passed from the private sector to the public sector? How can a circuit breaker of debt be best implemented? Answers to these questions have clear bearing also for the Balkans as shown further above.

Outlook Balkans (Croatia, Macedonia joint with Turkey)

Despite the candidate countries' heavy reliance on domestic funding, risks on the external side are also non-negligible since the external liabilities of the countries' banking sectors range between 13% and 20% of total liabilities. These external funding risks only partially materialised during the recent financial crisis, as none of the countries experienced a sharp reversal in external financing[7].

In Croatia and the Former Yugoslav Republic of Macedonia, external funding is mainly channelled through foreign-owned banks which in most of the cases headquartered in the EU and hold over 90% of the total assets. The presence of EU banks was generally considered to be a stabilising factor for the banking systems of the western Balkan economies given that their lending is less constrained by local shocks. However the crisis highlighted the potential for bi-directional spillovers, i.e. that shocks originating in the home countries of parent banks might also adversely affect subsidiaries.

However, the experience so far has confirmed the strategic and long-term interest of parent banks in the region. One indication is that the share of external liabilities in total liabilities increased steadily in Croatia and the Former Yugoslav Republic of Macedonia during the crisis. This suggests that subsidiaries did not experience severe funding strains. Overall, the banking systems in the three countries have weathered the strains in domestic and international funding sources during the crisis quite well. The endowment with high levels of capital contributed to this resilience.

Liquidity risks were also contained through abundant liquidity provision by central banks, but in the same way as a further deterioration in international liquidity conditions a possible further balance sheet restructuring in some western European parent banks in the wake of the current EU debt crisis could lead to a sudden deterioration in liquidity conditions for banking systems in candidate countries. If the reduced availability or higher cost of external financing prevail and domestic savings remain subdued, increased competition for retail deposits may raise funding costs and erode net interest margins in the future, which could aggravate

[7]On the post-crisis policy options of the Balkans see, for instance, WIIW (2011). For ways of strengthening macro- and micro-prudential supervision in EU candidates and potential candidates see ECB (2009). On 19 January 2010 the European Central Bank (ECB) and the European Commission signed an agreement to implement a technical assistance programme for EU candidates and potential candidates. The aim of the programme will be to strengthen macro and micro-prudential supervision in the Western Balkans and in Turkey. The programme, which is financed by the European Union, will last for two years and cost €2.65 million. See ECB (2010b).

pressures caused by still fairly robust but recently deteriorating profitability. The financial crisis would be back on the scene (Darvas, 2010, ECB, 2010). Seen, on the whole, thus, the future economic and non-economic welfare of the Balkans will be heavily dependent on a proper and sustainable institutional solution of the EU debt crisis.

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