

The European sovereign debt crisis and its resolution framework

Based on: Giancarlo Corsetti, Aitor Erce and Timothy Uy (2017) “Official Sector Lending Strategies During the Euro Area Crisis”. Cambridge-INET Working Paper Series No: 2017/12

Jean Pisani-Ferry, André Sapir and Guntram Wolff (2013) “EU-IMF assistance to euro-area countries: an early assessment”

Silvia Merler Jean Pisani-Ferry (2012) “Sudden stops in the euro area” Bruegel Policy Brief

The European crisis

- 23 April 2010, the date on which Greece requested official support from the International Monetary Fund (IMF), first European country after 40 years.
- IMF deals mainly with emerging countries
- The first official assistance programme in favour of Greece, in May 2010, consisted of an IMF loan and a series of bilateral government loans. It was not a joint European loan (lack of infrastructures of this kind in EZ)
- **Which kind of crisis was Greece facing?**

There are typically three kinds of financial crisis

Balance-of-payment (BOP) crises:

- potential threat to most countries.
- country unable to honour its international financial commitments in case of a sudden stop in net capital inflows because of a shock or a fundamental disequilibrium

Banking crises:

- They are normally dealt with by the sovereign
- It was later understood that the strong links between banks and sovereigns (“doom loop”) could severely affect eurozone

Sovereign debt crises:

- not specific to any particular policy regime
- BUT countries where the sovereign **borrowed in foreign currency, countries in a monetary union**, are **more vulnerable** because they have relinquished the option of debt monetisation (for member states: absence of lender of last resort);

The situation in the EZ was comprising some of these features

1. In the first years of EZ some member countries experienced consumption booms, **real exchange rate appreciation** and **large current account deficits** (see next two slides) which are typical before a Balance of Payment (BoP) crises.
2. **Banks** with **assets** that are **not diversified** internationally also concentrate risks resulting from the potential insolvency of private agents and sovereign. Banks rely on the state as backstop.
3. **Tight interdependence between banks, non-financial agents and the state** (see the picture Three Euro crisis) increases the risk perceived by the markets that decline or avoid financing agents that reside in a country, irrespective of their financial health (doom loop)
- In addition, in order to avoid sovereign debt crisis, EZ had adopted a strict fiscal surveillance (Stability and Growth Pact rules) and no bailout rule, but **no management of crises was put in place.**

Competitiveness indicators

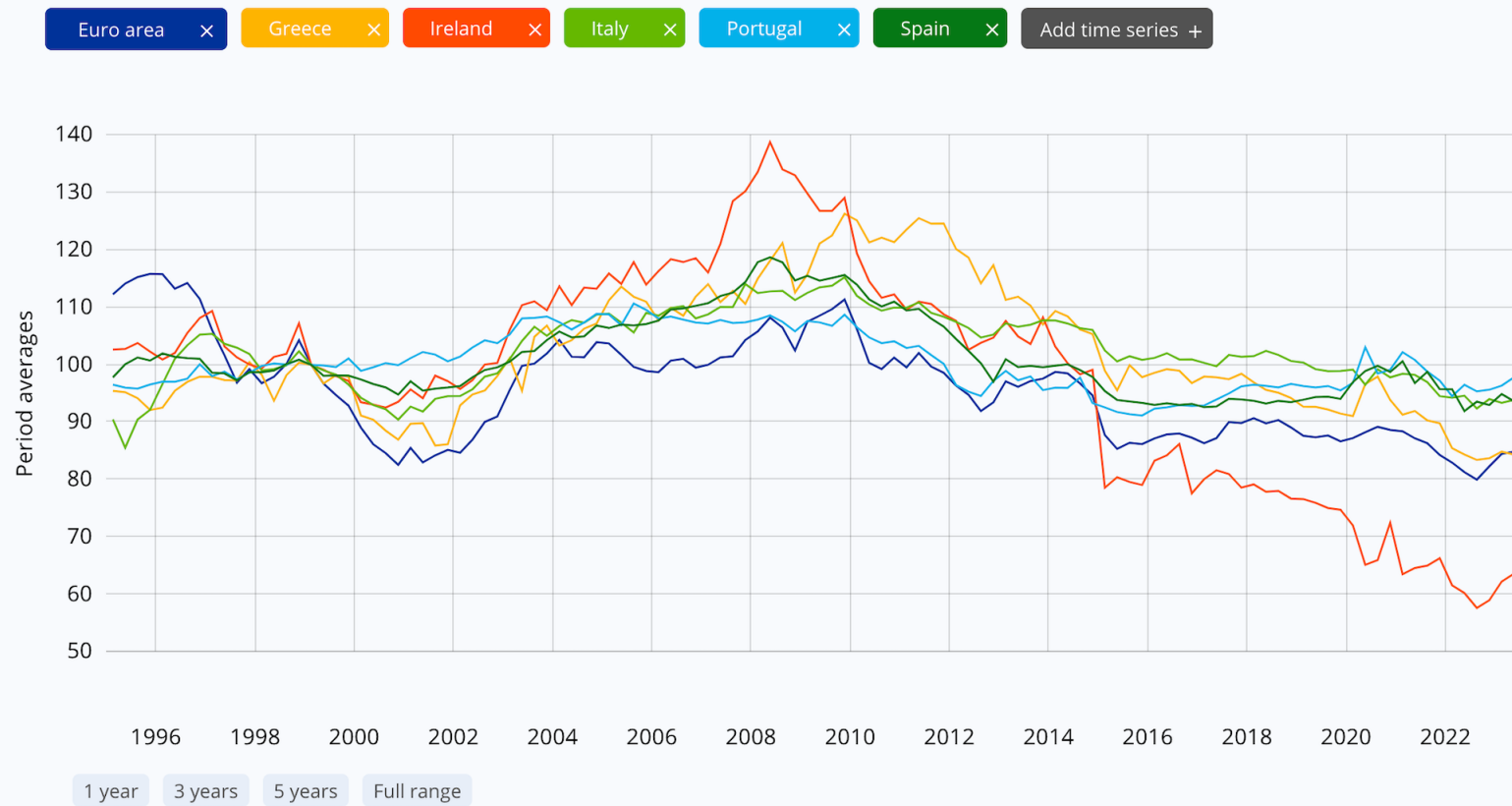
Choose indicator

Unit labour cost



Euro area, Q2 2023, Provisional value

84.89



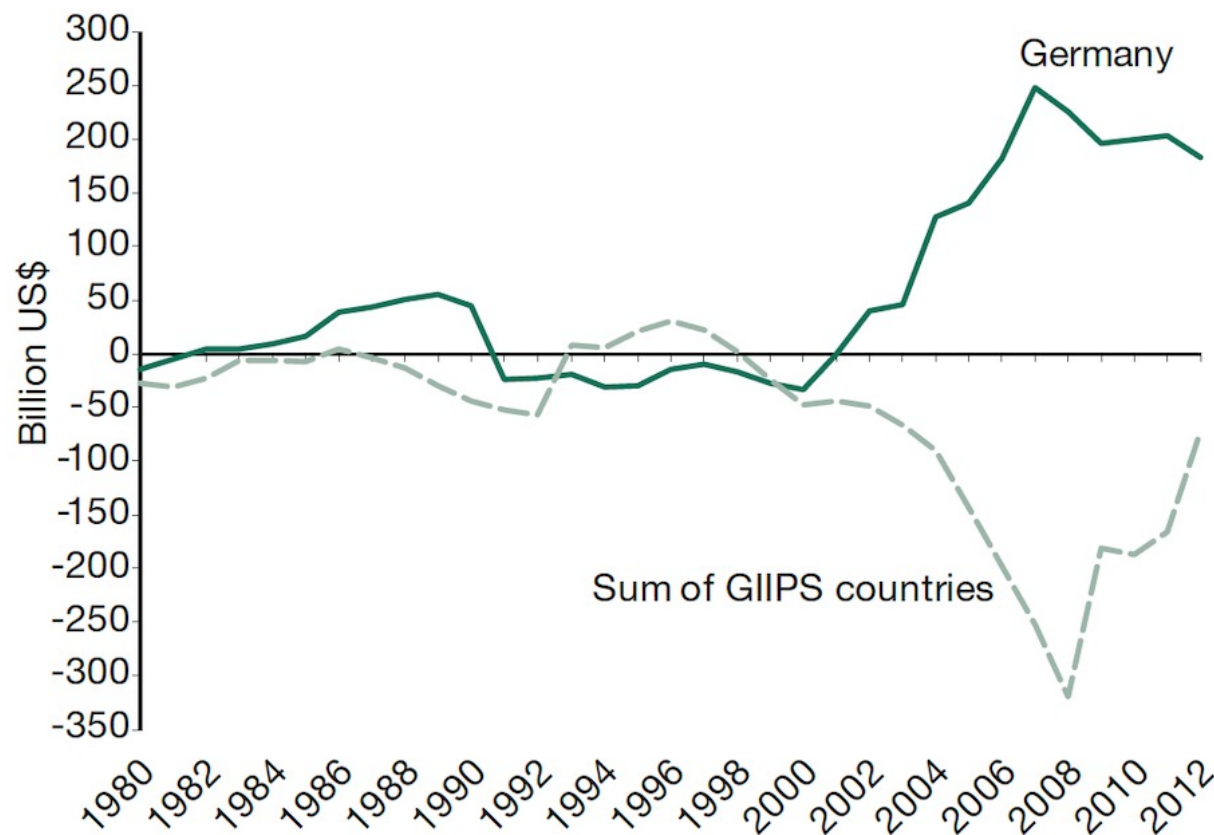
Source: ECB

European Economic Policy 2026-27

Current account (% of GDP)
2008 q1

-14.52	Greece
-11.64	Cyprus
-10.33	Portugal
-9.86	Spain
-6.87	Ireland
-1.72	Italy
-0.64	Euro area
-0.46	France
2.68	Belgium
4.20	Austria
4.22	Finland
6.28	Netherlands
6.80	Germany
8.22	Luxembourg

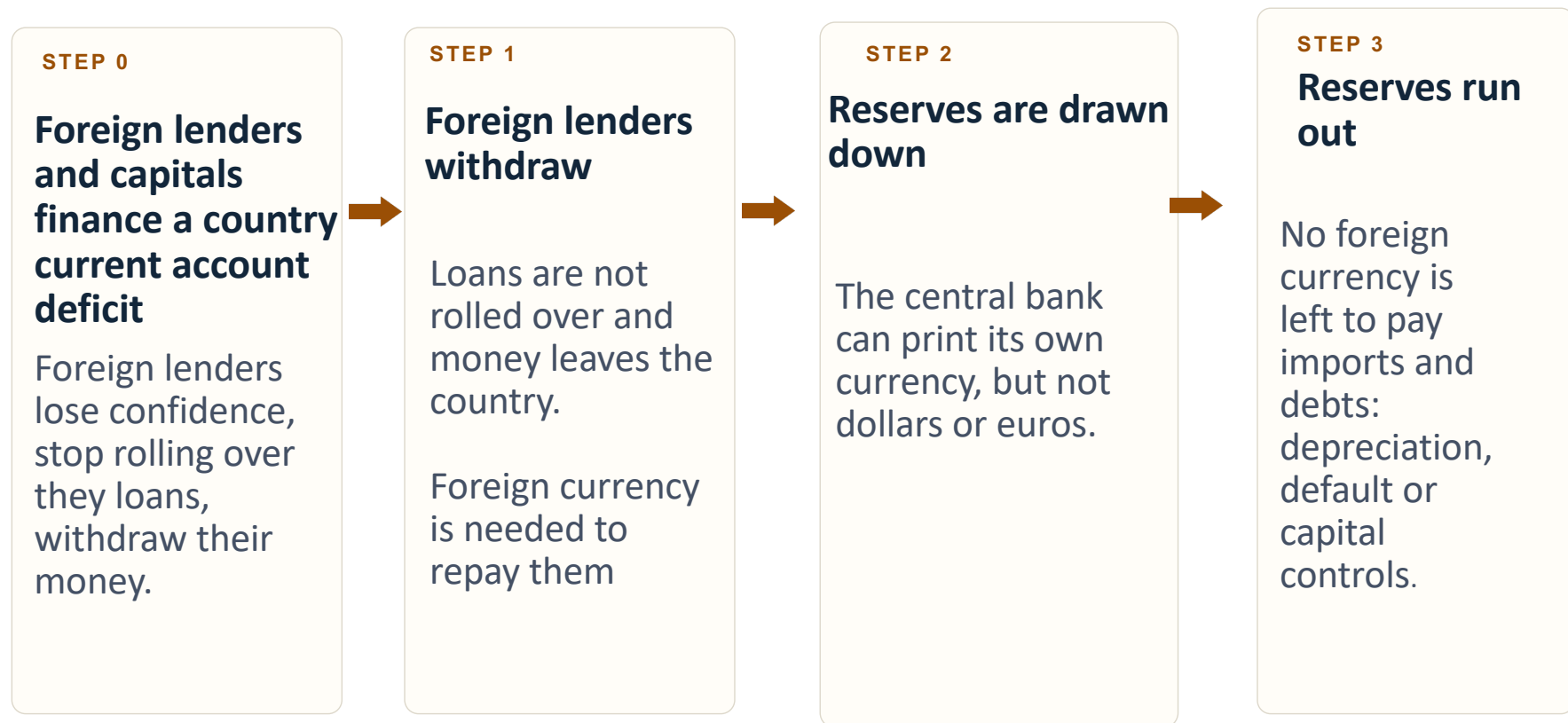
Current account balances of Germany and GIIPS countries



Source: IMF.

Source: [Intereconomics](#) Volume 48 · January/February 2013 · Number 1
Fiscal Divergence, Current Account Divergence and TARGET2 Imbalances in the EMU
[José Abad](#), [Axel Löffler](#), [Gunther Schnabl](#), [Holger Zemanek](#)

A normal balance of payments crisis



The core problem is a hard limit on foreign currency liquidity.

Balance-of-payment financing by the Eurosystem: TARGET2

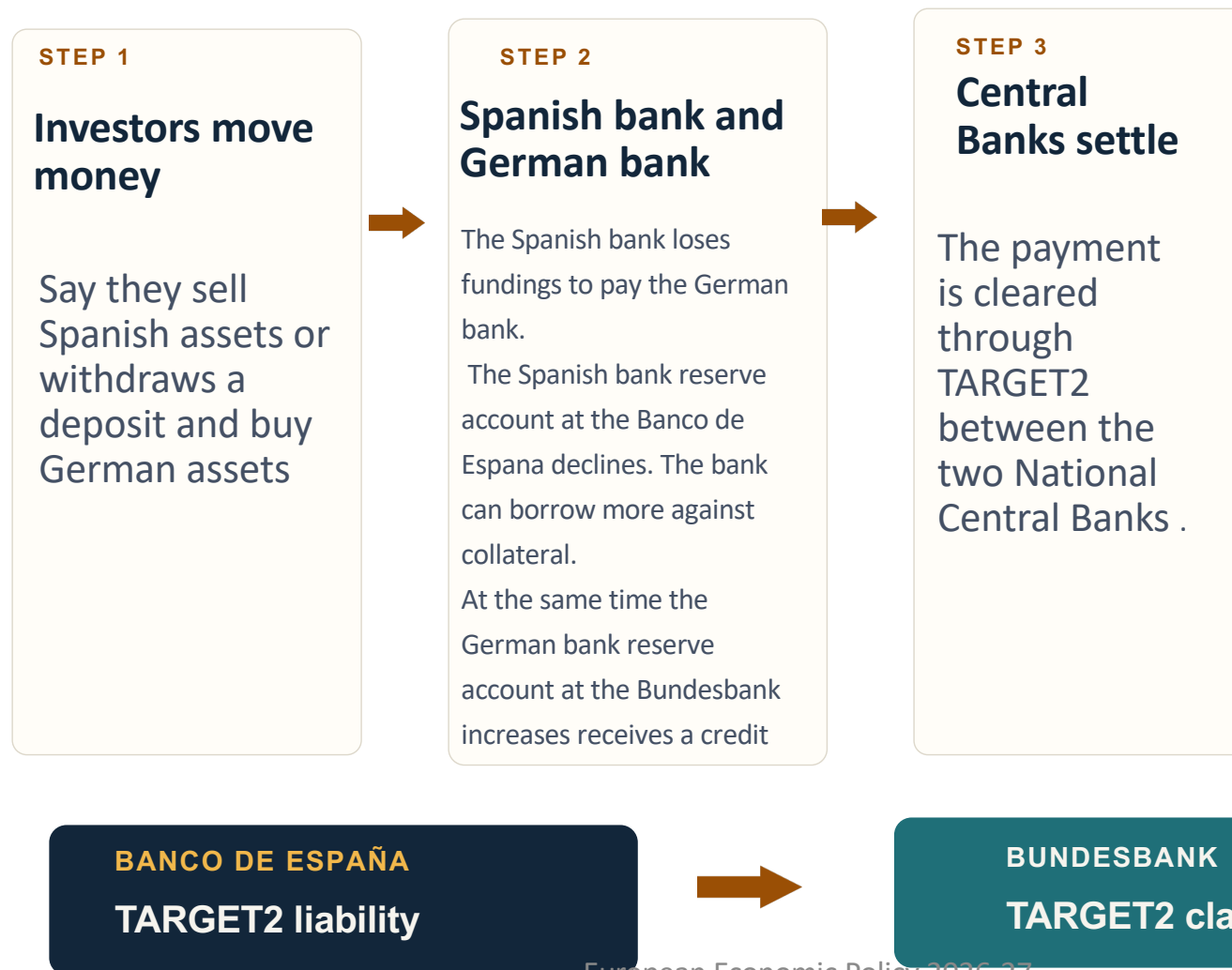
In normal BOP crises, the national CB cannot offset the withdrawal of foreign currency loans, which then leads to a BOP crisis.

In EZ the liquidity is provided by **TARGET2** Trans-European Automated Real-time Gross settlement Express Transfer system.

Target2

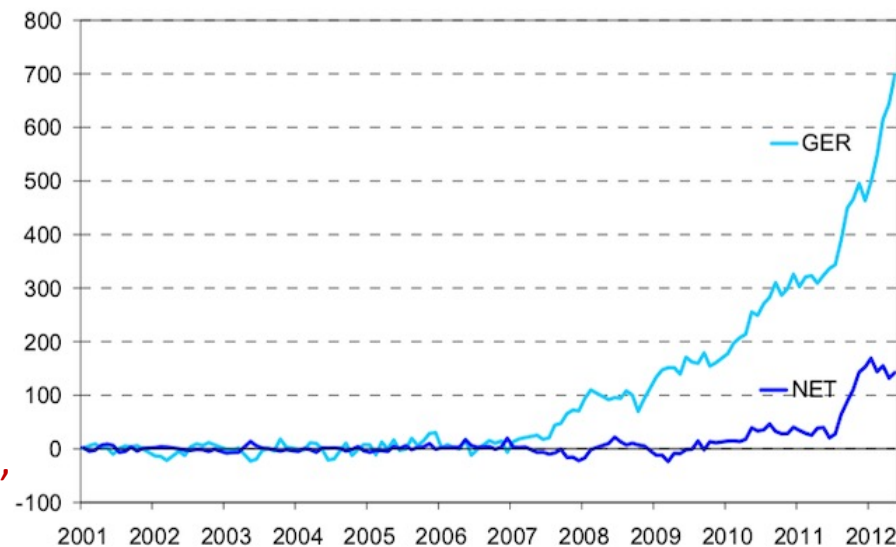
- A system that moves money from one bank to another, both within countries and across borders. Central banks and commercial banks use it to process payments in euro and move money safely and easily between them.
- The net flow of money between two countries (i.e. the total received minus the total sent) is recorded on the balance sheets of the National Central Banks of the two countries involved. The accumulation of these flows over time is called **TARGET2 balances**.
- If banks in one country have – overall – sent more money through TARGET2 than they have received, then the central bank of that country would have a **negative balance**. If they have received more than they sent, the central bank would have a **positive balance**.
- Notice: all the transfers related to the Eurosystem monetary policy operations are managed through TARGET2, so when the use of central bank liquidity becomes unevenly distributed across countries, TARGET2 balances will reflect it.

How a capital flight is recorded in EZ

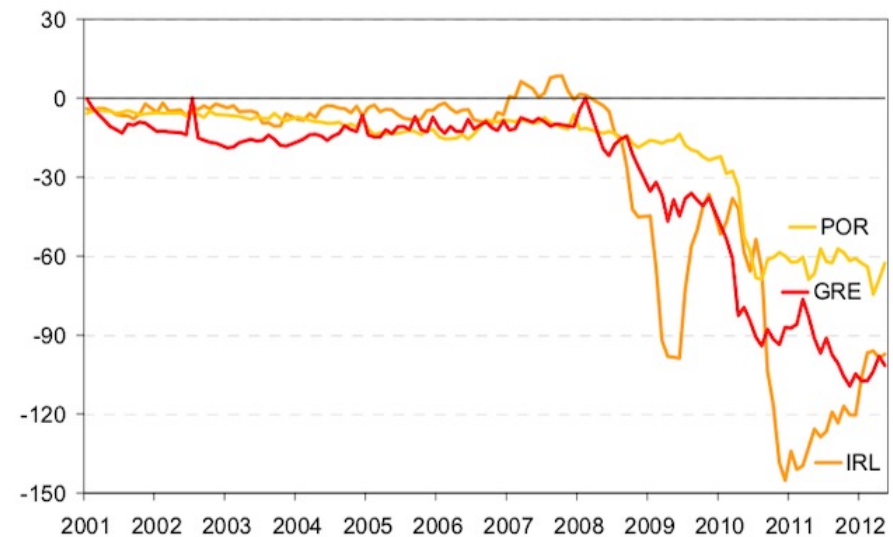
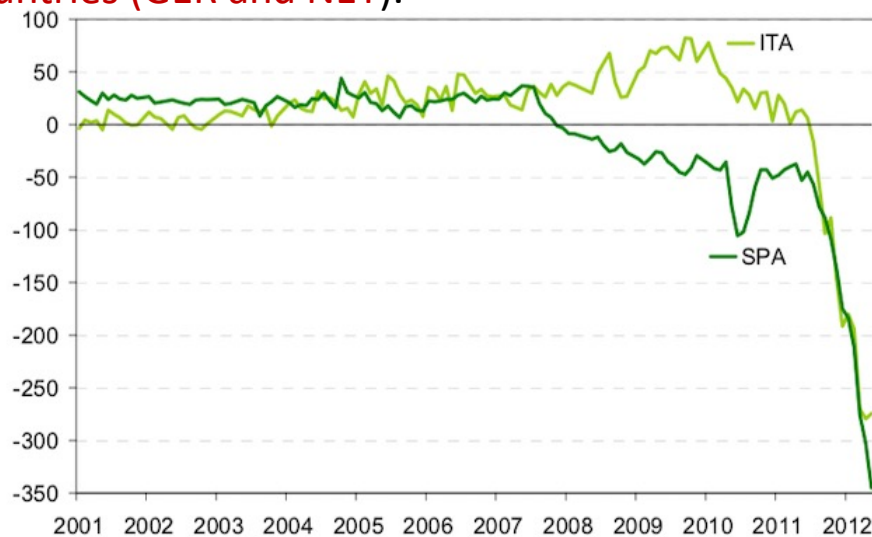


Until July 2007, TARGET2 positions were balanced overall: cross-border payments were flowing in both directions and were netted out to zero at close of business each day. The beginning of the financial crisis in August 2007 led to one-direction flows from “peripheral” countries (GRE, IRL, POR) to “core” countries (GER and NET).

Figure 2 - TARGET2 cumulated net balances
(monthly data; €billions)



The divergences widened with the outbreak of the sovereign debt crisis in May 2010. Since the summer of 2011, as the crisis has intensified and also affected ITA and SPA, divergences of TARGET2 positions have become even wider.



Source: NCBs balance sheets.

Source: Cecioni and Ferrero (2012) Determinants of TARGET2 imbalances. Questioni di Economia e Finanza (Occasional papers) Number 136 – September 2012

Notice that TARGET2 records:

- Net cross-border payments settled through central banks
- Payments for goods, services and interest, not only capital flows
- What private banks could not settle with their own funds and liquidity

What are changes in TARGET2 balances signalling?

- The steep increase in TARGET2 claims and liabilities from 2008 onwards suggests that tensions in the financial system may have an important role in explaining the divergence.
- In a period of financial crisis, banks in countries undergoing net payment outflows (e.g. deposit flights) need liquidity but can find it difficult to refinance on **the interbank market**, as in normal times (also because of the shortage of valuable collateral and loss of trust between banks), and will therefore resort more to **central bank liquidity** than banks in countries to which money is flowing.

(Merler, Pisani-Ferry, 2012)

NOTICE: In normal times, a German bank with surplus reserves would lend them back to Spanish banks (i.e. the short-term overnight interbank market). That recycling would make the TARGET2 imbalance small. During the crisis the inter-bank market largely stopped, because German banks did not trust the Spanish banks and did not want their risk. So, the liquidity went back to the periphery only through the Eurosystem, and the TARGET2 balances grew. The Eurosystem through the ECB provided the necessary liquidity in various way (see lectures on ECB monetary policy and unconventional instruments)

Symmetrical changes in the need of Central Bank provided liquidity

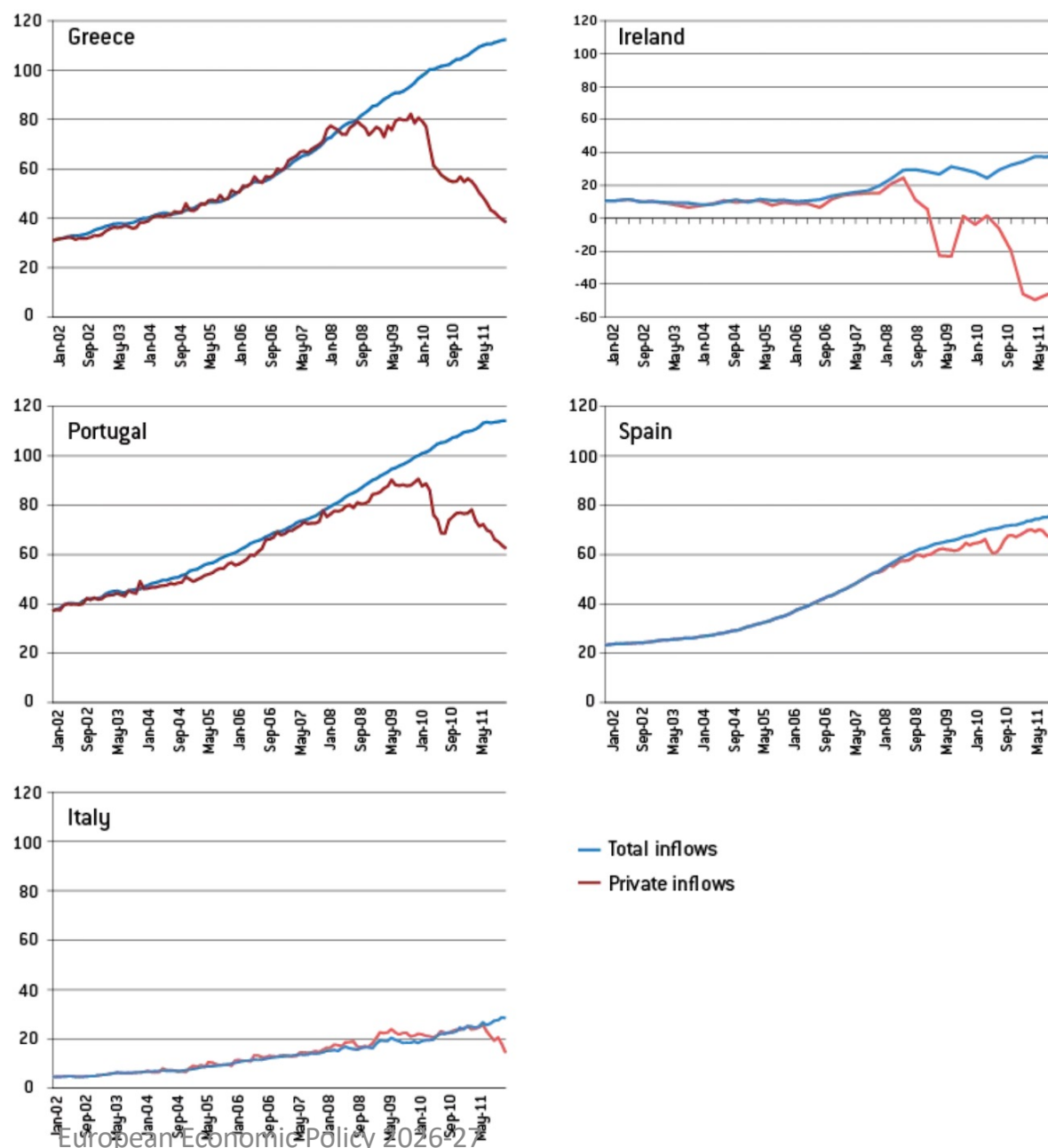
- Germany is a good example of this mechanism: the volume of central bank refinancing attributable to German banks decreased from €250 billion at the start of 2007 to €130 billion in 2010 (Deutsche Bundesbank, 2011b), signalling that **German banks have been reducing on average their reliance on central bank liquidity.**
- Symmetrically, demand for **ECB liquidity from banks located in troubled countries increased considerably** over the same period. In light of these considerations, TARGET2 imbalances can therefore be interpreted as evidence of a changing distribution in countries' refinancing operations, and as a compensation mechanism that allows sound banks in stressed countries to cover their liquidity needs.

(Merler, Pisani-Ferry, 2012)

Cumulated capital inflows (total and private) in proportion to country 2007 GDP

All five countries experienced significant private capital inflows from 2002 to 2007-09, followed by unambiguous and rather sudden outflows. In Greece inflows and outflows each amounted to about 40 percent of 2007 GDP. In Ireland inflows were limited but outflows reached 70 percent of 2007 GDP. In the other three countries outflows were less sizeable and started later, but nevertheless they were of significant size. (Merler, Pisani-Ferry, 2012)

Figure 2: Total and private capital inflows, selected southern euro-area countries, 2002-11 (% 2007 GDP)



The role of cross-border capital flows

- In EZ, the Eurosystem or ESCB (European System of Central Banks) balances financing gaps from trade deficits or net cross border capital outflows through Target2 → no scarcity of means to comply with cross border payments

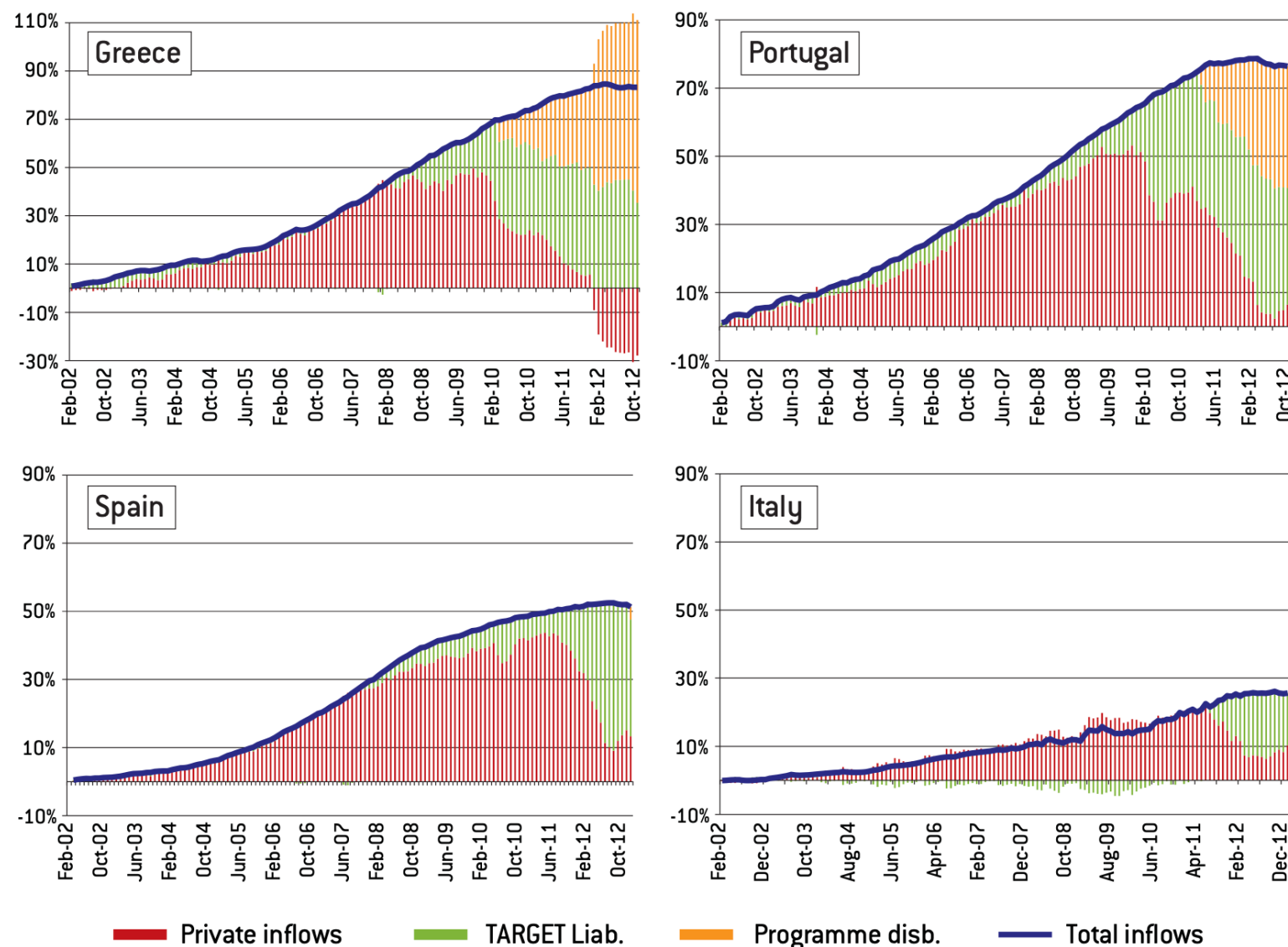
BUT

- Private capital may be withdrawn! So, the sudden stop can occur in *market* financing. This gave rise to
 - variable **spreads** and financial fragility
 - fragmentation of the cross border financial system
- **This kind of risk was underestimated** in the EZ, although there was an accumulation of **imbalances in internal current accounts**.

Private capital outflows were compensated for by an equally sizeable increase in public capital inflows

- Public support has taken three forms in the euro area:
 - provision by the **Eurosystem of liquidity** to the banking sector (captured by the development of TARGET balances); The eurosystem liquidity was provided in various ways (marginal lending facility, Main refining operations, longer term refining operations → see next lectures on ECB monetary policy)
 - EU/IMF assistance programmes;
 - ECB purchases of sovereign bonds under the SMP and successive programmes (again see next ECB monetary policy lectures)
 - Next figure shows the relative size and importance of the two first components in filling the void left by private capital flight.
 - The decomposition is obtained simply by cumulating separately:
 - changes in TARGET net *liabilities*,
 - programme flows,
 - measure of private capital inflows
- over the same period (2002-11) for all countries. The sum of these three components has been plotted against the cumulated total inflow (the official financial account data).

Figure 1: Private capital flows, programme financing and Eurosystem financing, Greece, Portugal, Spain and Italy, 2002-12 (% of 2007 GDP)



The picture shows the role of international financial assistance and Eurosystem liquidity in the case of two programme countries, Greece and Portugal, and in two countries, Spain and Italy, that suffered from capital-flow reversals but which did not apply for a programme. In Greece and Portugal, official financing has had to offset a complete reversal of private capital inflows accumulated since the beginning of the 2000s. This has been achieved through a combination of programme financing and Eurosystem financing. A nearly complete reversal of inflows in Spain and a sizeable outflow in Italy have been entirely offset by Eurosystem financing.

Source: Bruegel (updated from Merler and Pisani-Ferry, 2012). Note: Data for Ireland is not available on a monthly basis.

In Greece and Portugal: a complete **reversal of private capital inflows** accumulated since the beginning of the 2000s (in red). This outflow was entirely offset by official financing: Eurosystem financing (Target2) combined with programme financing.

BUT the Eurosystem does not provide unlimited financing of balance-of-payments deficits!

ECB liquidity is being provided within the framework of its normal procedures such as the Main Refinancing Operations (MRO) and Longer-Term Refinancing Operations (LTRO), as we will see in later lectures.

The Greek crisis and the initial response

- 2009: true size of the Greek public deficit/GDP (from 6.7% to 15.1%)
- The perceived capacity of the Greek government to pay its debts is actually lower than thought, and this triggered a **revision in the beliefs** of the creditors
- Euro area had no ready policy instrument to cope with drop of market confidence
- EZ economic governance: GSP + ECB no lender of last resort was thought to be sufficient for the 'no bailout clause'(art.125 TFEU) to be binding
 - **Art 125 TFEU prevented fiscal financing**
The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State,.....

Art.125 TFEU

The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

- This rule is intended to enforce sound budgetary policies by subjecting issuers of debt (Member States) to market discipline, which helps maintain the financial stability of the monetary union

But: contagion to member states with virtuous fiscal position (e.g. Spain) → called for a reform of the economic governance!

- EZ faced the contemporaneous task of
 - Responding timely to the crisis that was undermining stability
 - Reforming the governance
- Difficulties to converge to a shared policy view also due to polarized positions between
 - Creditors countries
 - Countries overwhelmed by the negative spillovers of the crisis

- March 2010: for the case of Greece, EZ agreed for IMF financial assistance + **bilateral loans** decided unanimously by lenders and **subject to conditionality*** assessed by EC, IMF and ECB (**Troika**) and Greek authorities.
- **EZ official lending framework was hampered** by very different views on the *rescue strategy* and the necessity to override the clause of art. 125

*three types of conditionality: **fiscal measures** aimed at reducing public debts and deficits; **financial measures** to restore the health of the financial sector; and **structural reforms** to enhance competitiveness.

- Note: the intervention of IMF also had to override a clause based on the **Debt Sustainability Assessment (DSA)**, which did not hold for Greece at that time! And which had to hold in the case of exceptional access policy (EAP), i.e. in excess of an annual limit of 100 percent of the member's quota.
- The IMF pressured by the risk of a systemic fall down of the financial system introduced the “systemic exemption”, i.e. the DSA could be derogated to the extent that the looming crisis could become systemic.
- Same exemption invoked to rescue Portugal and Ireland
- Note: the exemption clause was repealed in 2016; since then, a bailout when debt sustainability is uncertain requires that other official lenders commit to cover potential financial losses.

The fundamental change: a joint framework

- May 2010 IMF Loan facility to Greece did not calm the markets; pressures extended to PT and IR
- Ecofin, 10 May 2010 moved from directly funded loans (cash directly provided to Greece) to public guaranteed loans (loans granted in case of need)
- Joint framework based on two temporary instruments: EFSF (European Financial Stability Facility) and EFSM (European Financial Stabilisation Mechanism).
- The mission of both the EFSF and EFSM is to safeguard financial stability in Europe by providing financial assistance to countries of the euro area.

The two transitory mechanisms: EFSM and EFSF

EFSM allowed the **Commission to borrow** on the financial markets on behalf of the Union under an implicit guarantee from the EU budget. The Commission then on-lends the proceeds to the beneficiary Member State.

- Under EFSM, the Commission fund has the **authority to raise up to €60 billion**.
- This particular lending mechanism implies that there is no debt servicing cost for the Union. All interests and principal on the loan shall be repaid by the beneficiary Member State through the Commission.
- The Commission borrows on the international markets

- European Financial Stability Facility (EFSF) provided funding for euro area Member States. In this case, the funds are guaranteed by the Euro Area Member States.
- EFSF was **authorised to borrow up to €440 billion** by issuing bonds backed by **guarantees given by the euro area member states** in proportion to their shares in the paid-up capital of the ECB.
- EFSF was agreed on May 9 2010, and EFSM on the next day.
- Both mechanisms could only be activated after the Member State concerned had made a request for financial assistance and a macroeconomic adjustment programme incorporating strict conditionality has been agreed with the Commission, in liaison with the ECB.
- Since 2012 the EFSF had been replaced by ESM (European Stability Mechanism) while EFSM is in place for future events but not used.

ESM: European Stability Mechanism

European Council 24-25 March 2011

It established a permanent mechanism of crisis management and it can be activated in situations of difficulties of a Member State.

The mechanism replaces the temporary EFSF; it provides for financial support to the country requesting assistance; the support is subject to strict conditionalities and a thorough solvency analysis:

- for countries considered solvent, the private sector would be encouraged to maintain exposures and the new mechanism would intervene with a preferential creditor status, second only to the IMF;
- if the analysis reveals a situation of insolvency, the Member State should first negotiate a debt restructuring plan with private creditors.

The lending capacity of the ESM is 500 billion euros. Guarantees are provided by individual member states

Since 2011, the ESM has been the fund that grants loans to member countries in financial difficulty

ESM: European Stability Mechanism

ESM finds its legal basis in Article 122 (2) TFEU: "Where a Member State is in difficulty or is seriously threatened with serious difficulties as a result of natural disasters or exceptional circumstances beyond its control, the Council, on a proposal from the Commission, may grant Union financial assistance to the Member State concerned under certain conditions»

To activate the Stability Mechanism (ESM), Article 136 TFEU is amended and the following paragraph is added:

«3. Member States whose currency is the euro may establish a stability mechanism to be activated where indispensable to **safeguard the stability of the euro area as a whole**. The granting of any necessary financial assistance under the mechanism will be subject to strict conditionality.»

A note on the ESM

The legal basis introduced with the amendment of Article 136 authorises Member States to establish a stability mechanism on a fully intergovernmental basis.

In fact, there is no power of proposal and/or consultation for the European Commission and the European Parliament.

In addition, there is no direct intervention from the EU budget, with financial assistance being resolved in contributions from the States.

A note:

European Commission can borrow from the international capital markets

- EFSM is an example of the European Commission borrowing from the international capital markets, on behalf of the European Union.
- The EC is empowered to do this by the EU Treaty.
- The bond transactions are denominated exclusively in euro.
- The European Commission's largest programme is the [NextGenerationEU recovery instrument](#) of up to €850 billion in current 2018 prices – 5% of EU GDP. To finance it, the Commission is issuing securities on the international capital markets. About 30% of the funds for this programme will be raised through the issuance of [NextGenerationEU green bonds](#).
- The Commission also runs other programmes, under which it issues bonds to finance loans to EU and third countries. These include the up to [€100 billion SURE programme](#) to support jobs and keep people in work, financed exclusively through social bonds.

Other changes introduced as a result of the sovereign debt crisis

- Stricter fiscal rules(changes to SGP)
- New, unconventional monetary policy instruments

Questions

- What is TARGET2 and what is recording?
- Why did TARGET2 record increasing unbalances starting from 2008-9? In which directions were such unbalances?
- Which temporary instruments did the EU put in place to rescue Greece?
- Before the crisis how did the EZ design induce EZ countries to maintain sound fiscal balances?
- Why did the Eurosystem 'substitute' the private capitals during the sovereign debt crisis?
- Was the Eurosystem liquidity sufficient for all EZ countries hit by the crisis?