

GOSPODARKA NARODOWA

10
(254)
Rok LXXX/XXI
październik
2012
s. 1-22

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Preserving EMU Depends on Success of ESM in Solving the Debt Crisis

Summary: The paper presents a systemic explanation of the ongoing debt crisis in the European Monetary Union (EMU). The way monetary policy has been conducted in the eurozone as well as ineffective management of both public and private debt created a systemic risk that in 2010 turned into a full-fledged debt crisis. The author's analysis of past EMU data, official internal and external forecasts and the way that debt negotiations have proceeded yield a number of conclusions. One of these is that the European Stability Mechanism (ESM) and the European Central Bank (ECB) are in a position to stabilize the debt situation for some time if they are flexible in their approach. However, this requires extensive cooperation between peripheral and central countries as well as within these groups.

This condition is necessary but not sufficient to stabilize the EMU, the author says. As most of the EMU countries are heavily indebted (a situation that applies to both the public and private sectors), a new system of financial regulations must be hammered out, along with instruments to allow the peripheral countries to grow out of their debt problems. That will not happen without a partial debt reduction and external assistance, the author says, as the heavily indebted economies will not be able to adjust, because of economic as well as political factors. As in all past debt negotiations, conditionality, comparability of treatment and moral hazard problems will play a role, the author concludes.

Keywords: debt, debt management, financial sustainability, EMU, ESM

JEL classification codes: F34, G15, G18, H63, H68

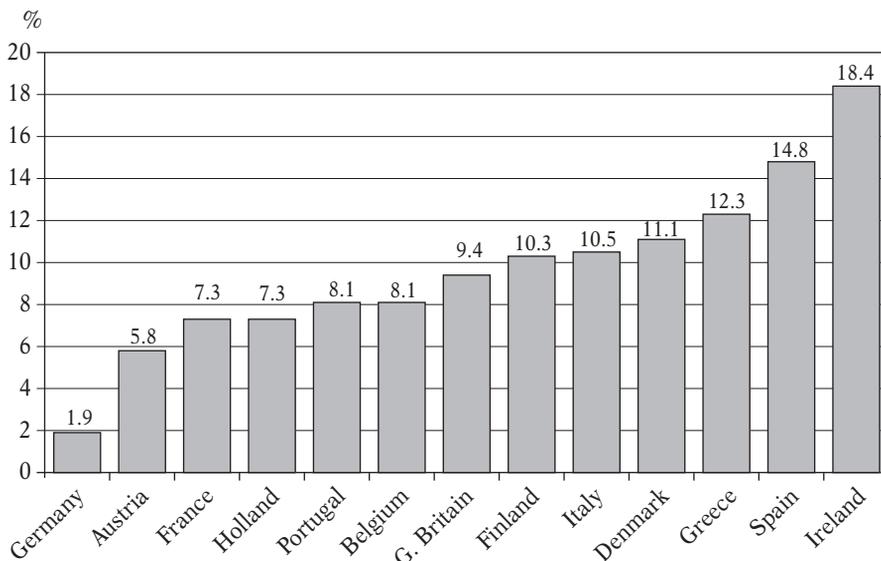
Artykuł wpłynął do druku 28 września 2012 r.

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Author wishes to express his thanks to Barbara Lundberg for her comments and support in getting the manuscript into good shape.

The road to financial unsustainability

When the European Monetary Union (EMU) was established in 1999, there was no political will in Europe to support the centralised fiscal policy [De Grauwe, 2007]. At the same time, the market was free of currency and credit risk¹, financial regulations were being liberalised [Eichengreen, 2011], so relatively cheap money was available. The long-term interest rate for 10-year debt securities dropped from December 1999 to December 2007 on average by 1.58 percentage points (with the average standard deviation of 0.57)². Credit security was implicitly granted by the whole union. Real interest rates were low in peripheral countries as inflation was higher than the ECB interest rates. All that made risky deals looked attractive as “marginal borrowers were ostensibly able to afford the financing costs” [Rickards, 2011]. Private finances skyrocketed as a result of cheap and secure credit. It was also easier for the public sector to increase debt while keeping the debt/GDP ratio under cover. Financial liabilities in the Eurozone economies rose by 8 per cent on the yearly basis, accompanied by falling net financial assets (by 1.2 trillion euros). The Eurozone functioning was accompanied by Fed experiments with sustained low interest rates.

Figure 1
MFI credit – yearly average increase in the period 1999-2007



Sources: Author's calculations, ECB, AMECO

¹ There were implicit guarantees of the EMU for all debt incurred by the member states.

² Half of that difference kept the American bond market low, which adds to the asset bubbles rise.

At those times, all economic sectors got their share of external financing, although, contrary to some popular opinions, the public sector benefited less. As a result of the vigorous activities of monetary financial institutions (MFI) the main economies of the EMU were heavily indebted by 2008. Spanish debt amounted to 366 per cent of GDP, in Italy that ratio was 315 per cent of GDP, in France – 323 per cent of GDP, in Germany – 285 per cent of GDP³ – see also Figure 1.

The rapid growth of external financing caused significant structural changes within the national balances of the EMU countries. Between 1999 and 2007 net financial assets fell in non-financial enterprises by EUR 2.9 trillion and rose almost at the same amount (EUR 2.7 trillion) in the households sector. At the same time, net financial assets of the public sector dropped by only EUR 745 billion. It is interesting that the consolidated debt of the public sector grew more in the central countries than in the peripheral economies⁴.

The stability of the highly leveraged financial system [MacKinsey, 2010] depends among other things on a proper evaluation of credited assets (financial and fixed). However, in the wake of financial liberalisation, the accounting regulations were changing, allowing for creative management of assets and liabilities and the acceleration of credit creation. Another factor was the separate handling by the regulatory authorities of traditional banking institutions and new organisations as hedge funds, private equity firms or special-purpose financial vehicles (SFV). The growing amount of artificial financial instruments, which *de facto* separated [Dembiński, 2011] banks from the real economy – i.e. production of goods and services, trade and investments – were through SFV removed further from the banks' balance sheets. The whole financial system became blurred.

As Goldman Sachs admitted during the Congressional Hearings [Congress, 2011], 20 to 30 per cent of their income was a result of derivatives operations and over 80 per cent of the profit from mortgage transactions was created by artificial financial instruments. Because of globalisation of the financial markets, one can hardly assume that the situation in the European banking system was different as the EU removed all restrictions to do business in other countries in the beginning of the 90's. The notional value of derivatives contracts (also used for the leverage purposes) amounted to USD 516 trillion in 2007 (BIS) and was rising in the period 2004-2007 at 33 per cent p. a. It continued to rise to USD 707 billion in July 2011. The OTC instruments were not regulated as the Fed chairman told in 2003 the US Senate (in his customary oblique

³ Global Finance – <http://www.gfmag.com/tools/global-database/economic-data/10403-total-debt-to-gdp.html#axzz1h9gBAgYq>; Economist, April 2, 2012, showed levels of debt as a per cent of GDP for a selection of rich countries and emerging markets <http://www.economist.com/blogs/graphicdetail/2012/01/daily-chart-8>. It appears that BRIC got twice less debt than the developed countries.

⁴ As the central countries we denote Germany, France, Holland, Austria and Finland; the peripheral economies are: Italy, Spain, Ireland, Portugal, Greece and Belgium. As EU we denote Eurozone plus Great Britain, Denmark, Sweden

way) that it would be a mistake to more extensively regulate the derivatives markets [Eichengreen, 2011].

At the NICE (noninflationary consistent expansion) times, as Marvin King called those years, the falling cost of capital allowed public debt service to decrease by 1-2 percentage points of the corresponding GDP level. But, instead of using this opportunity to improve public finances, several Eurozone countries (already in dire shape before 1999) chose to increase social transfers above the GDP growth levels. Table 1 presents changes in the social transfers compared with the growth of the corresponding GDP in 2000-2008.

Table 1
Social transfers change minus GDP growth (average 2000-2008)

Germany	Belgium	France	Spain	Italy	Greece	Portugal	Ireland
-0.9	0.4	0.6	1.0	1.5	3.4	4.1	5.1

Source: [Sawicki, 2011]

The growing social transfers should have led to more convergence in the EMU actively supporting internal equilibrium (unemployment dropped in all peripheral countries but Portugal). But the welfare policy carried out in most countries did not lead to the required competitive structural changes. Instead, it caused a growing dependency of those economies on external financing.

The credit policy of MFI in the EMU was *de facto* endorsed by financial authorities as it allowed GDP to rise in all countries, even if it were not particularly fast developments. In 1999-2008, the average real GDP growth (weighted-GDP) in the core economies amounted to 1.89 per cent p. a. In the peripheral countries, the results were better as the real GDP rose by 2.29 per cent p. a. and output gaps diminished (see also Table 2), total consumption climbed by 5.8 per cent p. a. and gross fixed private capital formation mounted more than 6 per cent annually (GDP-weighted in current prices in 1999-2008).

Table 2
Cumulated output gaps (-)

	1993-1998	1999-2007	2008-2011
	(in %)		
Central countries	-42.5	3.7	-50.0
Peripheral countries	-64.5	37.0	-110.1
D.S.	-23.1	5.8	-39.4
C.P.H.	-5.3	28.7	-21.1
Great Britain	-3.9	9.7	-10.1
EU-17 average	-8.0	4.4	-13.0

Source: Author's calculations based on AMECO, OECD, ECB; D.S. represents Denmark and Sweden; C.P.H. – Czech Rep., Poland and Hungary

These economic results were accompanied by a rapidly rising credit impulse⁵, which made GDP more and more dependent on external financing. The fact that there were no corresponding changes of the competitiveness created in the whole EMU seeds of non-stationary systemic risk. Falling current accounts and persistent budget deficits, not only in the peripheral countries, were widely observed. Between 2000 and 2007, Greece was in violation of the 3 per cent rule all the time, Italy 5 times, Portugal and Germany 4 times and France 3 times. Yet despite the falling resilience of some of the EMU economies, as late as December 2009, 10-year Greek bonds were only by 0.21 percentage points more expensive than German Bund, while the bonds of other PIIS (Portugal, Italy, Ireland and Spain) were only 0.13 percentage points lower on average.

Why the EU authorities did not respond to at least some of the non-stationary expansions of assets and liabilities remains a mystery. Financial liabilities were rising at extraordinarily rapid rates; yet external financing did not affect an appropriate rise in GDP. As the credit impulse grew, accumulated liabilities were bound to climb further if GDP stagnated and interest rates went up increasing the possibility of systemic risk⁶. The evolving of non-stationary systemic risk [Bisias et al., 2012] in Ireland and Spain was also obvious as household indebtedness was at accelerating path mainly because of housing credits. In Spain over one million houses were constructed, which were not sold, and in Ireland over EUR 400 billion of debt was accumulated when prices went up by 60 per cent over 4 years up to 2008.

In the central countries, the average GDP growth at current prices in the period 1999-2007 amounted to 3.4 per cent, while in the peripheral countries it was 5.5 per cent. At the same time, the domestic credit to private sectors rose in the central countries by 7.2 per cent on the yearly basis and by 17.2 per cent in the peripheral countries. The credit acceleration was accompanied by the falling marginal productivity of credit in almost all EMU economies making the least resilient economies vulnerable to the credit supply, its costs and conditions.

Table 3
Average income (GDP) elasticity of credit in the private sector in the selected periods (in %)

	1970-1980	1980-1990	1990-2000	2000-2007	2007-2010
World	1.0	3.5	2.3	0.3	0.3
Eurozone	3.1	0.4	2.4	3.3	3.9
Central countries	4.6	0.6	1.7	1.3	3.6
Peripheral countries	0.6	0.4	4.0	7.0	6.7

Source: Author's calculations based on World Bank, AMECO

⁵ Defined as relation between credit and the GDP.

⁶ The origin of the systemic events throughout history seems to be the four "Ls" of financial crisis: liquidity, leverage, losses, and linkages [Bisias et al., 2012].

Data in Table 3 show the average income elasticity of credit (measured in GDP in USD) in the private sector. It represents demand for credit caused by one per cent increase of GDP, at the chosen time. The inverse of the numbers shows the effectiveness of the credit, efficiency expressed in GDP. That simple analysis shows that the effectiveness in the peripheral countries in 2000-2007 was much lower than in the central countries or in the world economy. The financial crisis of 2008 made the situation much worse. This also explains the current debt situation in the EMU.

How the financial crisis exposed the deficiencies of the EMU

The financial crisis of 2008 placed the EMU economies under a serious pressure. World financial markets became volatile, inter-banking relations halted; wholesale market stopped supplying funding thus making normal banking activities difficult or impossible. The financial distress hit the European financial sector especially hard because it was highly leveraged, with term mismatch of assets and liabilities. According to the ECB, it amounted to around EUR 6.6 trillion in 2007. Books of the European banks were loaded with unreserved sovereign papers (as accounting regulations consented) and other risky assets. Short-term funding constituted more than 50% of the overall financial sector liabilities in 2007.

The difference between consolidated and non-consolidated liabilities was over EUR 6 trillion (i.e. 41 per cent of the consolidated assets of the sector) as a consequence of the swift development of the mutual inter-sector business⁷. The systemic crisis was amplified when financial institutions increased their exposure to the public sector in 2008 and 2009 instead of deleveraging [Klinz, 2011]. The asset illiquidity crisis resulted in falling values, asset fire-sales and self-reinforcing funding shortfalls.

Some deficiencies of the EMU were known from the beginning, and there were several symptoms of growing instability before the financial crisis. However, there were no signs of any adjustment of the existing fiscal management (not to mention fiscal federalism). And there was no coordinated supervision and regulation of the banking sector. On the contrary, Europe pursued a liberal policy in line with the deregulation in the USA⁸. Capital requirements were evaded in USA with the assistance of the regulators as Recourse Rule 2001 offered incentives for banks to hold securitized mortgages for 20% risk rating rather than the 50% risk weighting applied to mortgages. In EU bank regulators imposed zero capital requirements on banks' holdings of euro-denominated government debt not to disturb confidence in the EMU system. All these and other regulatory decisions add to the leverage cycle [Shiller, 2012] upholding

⁷ As P. Krugman calls the financial sector "the internal organisation of intermediation" - <http://krugman.blogs.nytimes.com/2012/01/22/notes-on-deleveraging>

⁸ Starting with Commodity Futures Modernization Act and Gramm-Leach-Bliley bill [Haldane, 2011].

a tendency” to regard the governments as the ultimate saviour”. The lax regulations of the financial system, together with the principle of home country control and host country responsibility, were accompanied by the helplessness of the European Commission not able to execute even the weak rules of the debt management agreed upon in the Stability and Growth Pact and other Maastricht decisions⁹. The fragmented and uncoordinated reporting system of financial supervision left the governments in 2008 blind to what was happening and what was going to happen if one of the economies in the EMU declared itself a bankrupt.

The growing intertwined financial system created a complex web composed of cross-holdings of debt [Rickards, 2011] not only in the Eurozone economies. Banks leveraged more than in the USA [MacKinsey, 2010] with capital buffers weaker than Citigroup, Goldman and other bailed-out American financial institutions turned out to be unstable, as H. Minsky had predicted in his “financial instability hypothesis” [Minsky, 2008], [Keen, 2012]. If we assume that the systemic risk arises endogenously within the financial system, consequently this certainly implies “that there should be measurable intertemporal patterns in systemic stability that might form the basis for early detection and remediation” [Bisias et al., 2012].

Northern and southern economies under the EMU umbrella strived to protect internal macroeconomic balances (employment, inflation) but both were implementing different and sometimes opposite growth policies. These strategies resulted in mounting twin deficits in the peripheral countries and surpluses in the central economies. In the peripheral countries, the GDP growth was financed mainly through current balance deficits. Cumulated current balance of the peripheral countries exceeded in 2010 EUR one trillion compared to 2002 when it was positive. These visible but incoherent convergence policies went uncontested (the EU was focused, if any, on budget deficits, not the foreign debt imbalance).

The structural problem surfaced with the onset of the financial crisis. The level of public debt mounted, while GDP growth was sinking. The public sector became unsustainable as it turned out that it was not possible to increase the systemic reserves in form of taxes, expense reductions or stock flow changes and relations between GDP growth and interest payment levels began to worsen. European anti-recession measures represented 2 per cent to 4 per cent of GDP in 2009 and 2010. Although being less comprehensive than actions taken in the USA and Great Britain, they were sufficient to destabilise absolutely the financial system of the EMU [Klinz, 2011]. Deleveraging, which started after 2008 within the private sector, was more than compensated by vast public borrowings. This increased the instability and eventually triggered the debt crisis.

⁹ The original SGP was suspended in November 2003 when ECOFIN broke down under the Germany’s and France’s pressure. A revised version of SGP was agreed in 2005 allowing for more flexibility.

To rescue the financial system in the Eurozone the ECB allocated EUR 600 billion to restore liquidity. Further instruments were implemented including EUR 300 billion public money to recapitalize the banking system and EUR 1.9 trillion in state guarantees (EUR 920 billion was allocated). In October 2009, the IMF estimated that the EU financial system would need EUR 1.2 trillion additional capitals. The ECB interventions in 2008 and 2009 calmed the market, while they made many MFI deeply dependent on the ECB for liquidity [Rickards, 2011]. The ECB decisions were not sufficient. In some cases, financial institutions had to be rescued directly by the public sector. The money needed for rescue operations was once more borrowed by the EU governments from the same financial system they already had supported.

The ECB was rescuing the liquidity at the market and, at the same time, was financing the indebted economies. The ECB provided funds to the banks, which, in turn, bought sovereign papers (ECB securities of euro area residents denominated in euro rise by over EUR 200 billion in 2009¹⁰). But no government and no banking community acknowledged at that time that the public sector in all peripheral countries had already depleted almost all available resources needed to service the debt inherited when the EMU was created and thereafter augmented during the next 10 years. In 2006 financial stability reports of the 47 central bankers concluded that financial system was in good shape. As late as 2010, the European Commission and the ECB publicly stated that the monetary union was performing well, which was stretching the truth at best.

The susceptibility of the EMU to foreign shocks became visible, when the weakest governments, the most dependent on debt availability and the soft credit conditions, were struck in 2010 and 2011. Then, at last, some slow changes concerning debt management started within the European Union. But the proposed modifications of debt management in form of the Pact for Euro, Euro Plus, were more like window dressing than any real attempt to reform financial management in the EU. In 2012, the Eurozone finally accepted the Fiscal Pact, which is a variation of the Euro Plus signed a year ago¹¹. Its capacity to enforce the decisions contained therein will soon be tested. As many experts acknowledged that the management of the financial system in the EMU is poor some adjustments concerning harmonisation of the financial regulations were proposed. Various organizational changes were carried out in 2010 when e.g. three European supervisory authorities (ESAs) were established. But still not much has been done to regulate concentration limits for financial companies, to oversee OTC, shadow banking and implement Basel III [Pykhtin, 2012]. At last the June European Council declaration "Towards a banking union" addressed some of these problems by proposing single rule book for

¹⁰ In December 2011, it was over EUR 600 billion.

¹¹ Also in the USA it took couple of years to suggest some more profound changes of the functioning of the financial system [Congress, 2011] as Dodd-Frank bill in 2010. Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) and Office of Financial Research (OFR).

6 thousand banks¹² as Single Supervisory Mechanism, with the involvement of the ECB (starting at 1 January 2013) and further recapitalization of the banking sector¹³. Apart from legal problems as for those banks which will be supervised by the ECB, the proposal, as it stands, creates a potentially confusing system of supervision by both the ECB and national regulators. There are three major steps in a banking union: the ECB being given responsibility for monitoring all Eurozone banks and others that sign up; a fund to close down and settle the debts of distressed banks; and a fully-fledged scheme to protect citizens' deposits. Germany and others are concerned that deposit guarantees will put them on the hook for banks in Greece or Spain. So Germany has been vocal in arguing that only the largest and most systemically important banks ought to be supervised by the ECB. The timetable of adoption of the necessary legislation is seen by Germany as unrealistic. Germany prefers to concentrate on big banks and would proceed rather cautiously. That of course is entwined with the ESM recapitalization task. Supervision is a condition for direct bailout funding for failing banks, a way around piling more debt on states' books. On the other hand, France is leading a bloc of Member States which support that ambitious timetable. As M. Brown observed – "If EMU wishes to develop a credible solution to the crisis in the Eurozone it needs to address the question of Treaty change at the same time"¹⁴. Meanwhile the UK, the leader of the few non-Eurozone countries clearly decided against joining the banking union afraid that does not turn into a mechanism for destroying the dominance of London as Europe's financial centre. On the other hand de Grauwe rightly notes that "People have been living under the illusion that banking union is a substitute for fiscal union"¹⁵. As if in response, on 13th September President of the European Commission presented to the European Parliament an ambitious programme for the formation of a European political and fiscal union.

The bailout and its consequences

The situation leading up to Greek bailout was not just the consequence of bad economic performance in the peripheral countries. It is not an accident that it coincided with the outbreak of financial crisis in the USA, as the effects of crisis increased asymmetry and deficiency of the information within Europe. The decision-makers in the EMU countries neglected the existence of the non-

¹² This will include all Eurozone banks, subsidiaries, but not branches, of banks located outside the Eurozone, whether elsewhere in the EU or in the US, for example.

¹³ Nomura in June note that non-performing loans could cost the region's 90 biggest banks €420 billion not only in Spain, or Italy but also in Germany, France and United Kingdom-
<http://www.economist.com/node/21556624>

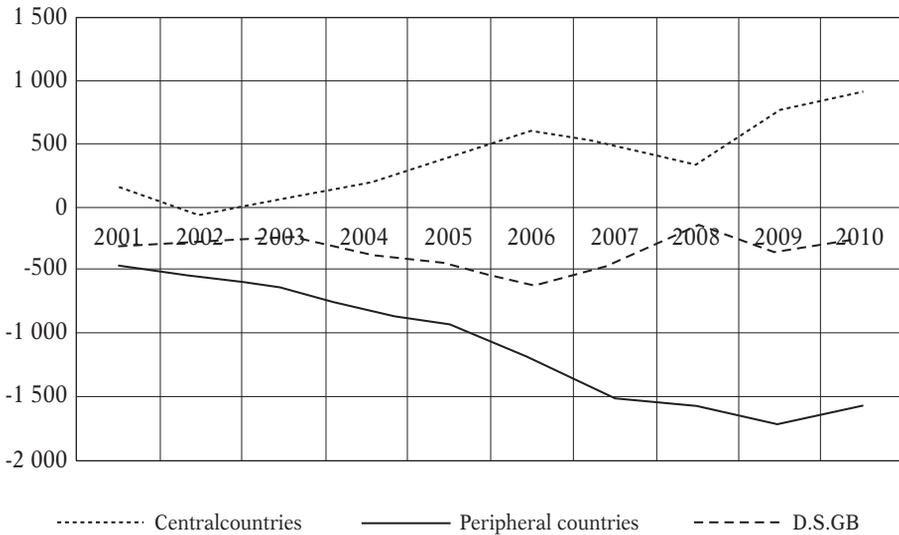
¹⁴ <http://www.mayerbrown.com/files/Publication/a8be387d-2ae4-4963-a9a2-314a56344e1c/Presentation/PublicationAttachment/b0aba13f-9318-48e9-985f-e80a6263af76/EuropeanBankingUnion.pdf>

¹⁵ <http://www.reuters.com/article/2012/09/18/us-eu-bankingunion-idUSBRE88H00120120918>

stationary systemic risk because they did not understand the situation and were not organised appropriately to respond to the rapidly changing external conditions.

There were different reasons for this situation including the negligence of the evolving information characteristics (non-symmetrical, path depended, framed, heuristic, herd instinct¹⁶). It was more convenient to believe in efficient market hypothesis – for both sides: financial and governmental – than to investigate the real economic situation of each of the economic sectors. As M. Spence put it, “there was a widespread view that the system was largely self-regulating, within important proviso that its various parts (domestic economies within nations) were properly managed” [Spence, 2011]. That also revealed lack of the leadership in the European Union where the cohesion between the north and the south did not increase during the existence of the EMU – compare Figure 2.

Figure 2
International investment position (billion euros)



Source: Author’s calculations, ECB, AMECO

In 2010, the economies of the weakest EMU members were principally defenceless. The Treaty does not allow the bailout of other economies. One common central bank was not able to monetise debt and a single currency did not allow for increasing competitiveness through currency devaluation. The principles and rules of the EMU left the overburdened economies with an austerity policy and the internal devaluation as the only instruments available.

¹⁶ Virtually every financial crisis in the last century has been pushed over the edge by the herd instinct.

Greeks' request for a bailout in April 2010 created havoc as the cost of Greek bankruptcy was unknown as was the division of those costs between the EMU economies. It was obvious that the bailout meant double moral hazard: first (i), because of the Greek rescue and second (ii), because of the asymmetry of the responsibility between the financial system and the public sector. But the government's decision to bailout Greece was the only choice with the hindsight if the central countries decided to support the existence of the EMU. Other possibilities were dim and uncertain. There was no negotiating platform for debt reorganisation (in the form akin to the Paris Club), the IMF interference was not welcome, and there was growing external pressure of the G-20 to stabilise the debt situation.

On the other hand, the disintegration of the EMU could have serious consequences for the central economies, as well as for the peripheral countries. EMU disintegration meant: (i) new cost to preserve equilibrium under new circumstances, (ii) the disappearance of a reserve currency, and (iii) damage to the political and economic status of the European Union [Laqueur, 2011]. There were no exit rules in the EU Treaty, so every solution would have been arbitrary and disorderly. For the peripheral countries, leaving the EMU would leave the country with the destroyed and isolated financial system as well as with growing foreign debt, but with an independent monetary and currency system. In any case, leaving the EMU appeared to the peripheral countries an expensive way of defaulting [Sawicki, 2011]. But it does not mean that political decisions could not proceed in that direction. Disintegration of the EMU would also influence the central economies in the unpleasant way. For Germany, it could mean appreciation of "their" currency, regardless of whether it would be the national currency or the new money in the newly constructed, this time by the central countries, monetary zone. Changes in the current surpluses would increase public deficit or encourage banks to increase credit to private sectors; both solutions would be politically unwelcome. In France, the growing current deficit would force the government to squeeze its budget further allowing private sectors to deleverage, but unemployment to grow.

The differences between France and Germany in the proposed methods of alleviating the debt crisis were already visible during the presidency of N. Sarkozy. French officials openly disagreed with Germany on its austerity policy and the independence of ECB." Germany, for historic reasons, closed the door to the direct involvement of the ECB"¹⁷. The arguments were simple – the austerity, rather making it easier to pay down debts, could make it harder – and more expensive. The long-lasting differences between Germany and France in understanding of the role and of the importance of monetary policy of the central bank D. Marsh presents [Marsh, 2011]. But the German opposition to the austerity policy easing has important merit. Germany's euro problem is that Germany "cannot have all three: perpetual export surpluses, a no transfer/no bailout monetary union, and a "clean" independent central bank"

¹⁷ Mr Baroin cited after [Irishtimes.com](http://www.irishtimes.com/); <http://www.irishtimes.com/>

[Bibow, 2012]. The true choice facing Germany is to either bail out its bankrupt EMU partners or its own banks (after the latter got hit by EMU partners' defaulting on their debts). The same problem relates to so called Eurobonds. Germany understands that once debt is pooled, entitlements become pooled as well. "A transfer union across the existing single currency zone based on the Canadian model would seek to make governments' revenues more equal". The estimates predict that such a system would cost Germany the equivalent of 3 per cent of GDP annually [Ibbitson, 2012]. On the other hand, the German opposition makes the Eurozone seem to be renegeing on its commitments to the G-20 process of global rebalancing and drives Europe into double dip recession.

The past financing crisis has also caused budgets to plunge and public debt to rise. History teaches that public debt typically rises by over 80 per cent three years after the outbreak of the banking crisis. This is accompanied by a severe drop in GDP and an increase in unemployment [Henry, 2004]. B. Eichengreen estimated the cost of the banking crisis for the period of 1973-1997 at 9-12 per cent of GDP [Bordo, 2000], [Reinhard & Rogoff, 2009]. Bailouts although costly in the short term were considered as less demanding than the decisions to let the banking system collapse.

First decisions to bail out Greece involved directly public money¹⁸. Subsequently to bailout of Ireland and then Portugal, the special purpose financial vehicles were created. Under the umbrella of EMU, countries guaranteed they were programmed to recycle market money to the indebted countries. Again it was decided within the EMU to resolve the crisis by using external financing. As the market sentiment did not improve, the ECB began to operate more vigorously in the secondary debt market. When the markets assaulted Italy and Spain, the ECB decided to inflate its assets more than Fed did in both QE actions, in order to restore confidence and diminish volatility. Over one billion of liquidity, injected into the economy at the end of 2011 and the beginning of 2012 helped to calm the bond market but did not restore the credit financing of non-financial sectors. For the velocity of money is a function of consumer and investor confidence therefore the "supply transmission mechanism from base money to bank loans can break down". So it was to be expected that many banks, which took ECB money, later invested it into safety instruments (like the sovereign debt) or deposited in the ECB (deposits in the ECB grew from May 2010 to May 2012 by EUR 750 billion). In the last 3 years, credit to the non-financial private sectors stalled.

Seeing from that perspective, the main problem currently lies in the trade-off between deleveraging of the banking sector, deleveraging that is required by the market and politicians¹⁹ and the demand for external financing of

¹⁸ Look also – The EU architecture to avert a sovereign debt crisis [Olivares-Caminal, 2011].

¹⁹ In October 2011, EU politicians demanded – on top of Basel III – that the banking sector in the EMU increased its capital and held at least a 9% core tier 1 capital ratio by the end of June 2012 – including marking to market all of their exposure to sovereign debt.

the real sectors. Banking system financing of the real economy is especially important in Europe, where 75-80 per cent of external financing is in the form of credit, not debt. So the credit supply was and still is perceived as the key to further growth developments. However, if there is, as we believe, overcapacity of external financing accompanied by falling marginal efficiency (measured by GDP), then the ability of the economies of the EMU to service their already accumulated debt is in question. The growing debt accumulation could very swiftly force the Eurozone to struggle with swelling instability as the risk connected with the level of credit impulse turns out to be non-stationary [Bagnai, 2010].

In these circumstances, the real problem lies not only in better supervision of banking activities but also in the remodelling of financial sector activity. Broken relations between savings and investments, lost track of the results of financial ventures, chains of interrelations created by the derivatives made the public system a hostage to the financial sector behaviour, since the bankruptcy applied to a broken institution does not alter the public responsibility for the national and foreign savings. It is a Catch 22 situation, as the present liberal financial system ensures that banks too big to fail (SDI-systemic dangerous institutions) cannot ever be grounded for being bankrupt even if they are. That raises different proposals of Tobin tax or other ways of taxations of the artificial banking activities. But banks will not change their *modus operandi* unless the system becomes tied to the real economy as it was before the financial engineering novelties were introduced. Derivatives were invented to reduce risk and allow credit to rise. By definition they were supposed to increase profits with lower costs, profit achieved not by costly insurance against tail risk but by pushing risk into the hands of others market participants. As H. Minsky wrote an innovative treatment of the banking assets and liabilities, "when banks went out of the storage business into the moving business" accompanied by the growing liberalisation, guides to growing casino behaviour [Minsky, 1992].

ESM as the final stage of debt negotiations in EMU

The success of the decisions to bailout Greece, Ireland and Portugal depended from the very beginning on two pillars: (i) the amount of resources available and the involvement of the ECB; and (ii) the capacity of the indebted economies to restructure. However, it was not the functioning of the SFV (as European Financial Stability Facility or European Financial Stabilisation Mechanism) or the involvement of the ECB, but implementation of the conclusion expressed in Deauville (informally), which influenced developments most. With the passage of time, it was clear that it was counterproductive to expect Greece be able to use in a short period its reserves (it means e.g. increase budgetary income, cut expenditure or privatise state properties) to meet all foreign obligations (deriving from the old contracts and the refinancing agreements) and re-enter the financial markets to borrow.

Historically countries in similar situations first refinance, then restructure and, after some time, reduce their debt burden. Typically creditors agree to digest the cost of debt reorganisation upfront and accept the debtor possibilities to repay the reduced debt [Plan, 1985], [Reinhard & Rogoff, 2009], [Kindleberger, 2005], [Feldstein et al., 1991]. Following that model, the Institute of International Finance did negotiate a reduction (over EUR 100 billion) of the privately held Greek debt. From that point of view, huge liquidity actions (LTRO – longer-term refinancing operation) taken by the ECB by the end of 2011 and at the beginning of 2012 judiciously complemented the bail-in decision.

The arising more and more difficult Spanish situation caused the ECB to go beyond so far taken actions. Draghi announced his Outright Monetary Transactions (OMT) initiative on September 6th, by which the ECB is permitted to unlimited purchase of the debt instruments with up to three years maturity, issued by member states whose budget deficits and debts are so high that they have been shut out of the financial markets. Draghi emphasized that any bond purchases by the ECB were conditional on governments signing up to the EFSF or the ESM program and will be subject to conditions imposed on the receiving state by the ECB, the European Commission and the IMF. The ECB on the one side overruled the German opposition for bank involvement in the rescue action. On the other hand ECB allowed the politicians to influence on the decisions of the bank. As ever, in the debt negotiations, three issues were most important: equal treatment of creditors and debtors, conditionality and moral hazard. At the very beginning of the negotiations, conditionality became most important as in the on-going disputes between creditors and debtor any result is possible and the externalities of the bailout process are difficult to assess. The EMU could have fallen apart if the rescue process turned out to be a failure. There was no legal way any country could be expelled or leave the EMU on its own in an orderly way. As it happened that not only Greece could have been affected by the on-going crisis the conditionality had to be strict, as to prevent others to follow the Greek path and demand similar concessions.

Conditionality applied by the “Troika” (EU, IMF and ECB²⁰) to all rescued economies referred to the needed structural changes (following the IMF method) but did not answer one important question. According to the restructuring programmes, the peripheral countries are bound to grow out of the debt (an exercise which was rarely successful in the past) [MacKinsey, 2010]. But in the applied austerity programmes, there is no reference to the source of financing of the needed transformations. With hindsight the developing countries efforts to overcome the crisis used to rely, to certain extent at least, on the exogenous assistance (IMF, World Bank, regional financial organisations, etc.). In the EMU, we deal with the developed economies, and it is a mystery to what extent they can count on that support. But it is obvious that without growth their debt will rise further and the ESM or any other debt reorganisation mechanism – operating between the budgets of the EMU core economies and the unwieldy

²⁰ So there is no one responsible for recovery programme for each economy.

system – will ease only rising tensions. At the same time the public finances of the paying countries will be loaded with the new commitments.

By the end of 2010, it was evident that decisions, which only responded to the arising crisis, turned out to be ineffective. So the resolution to create the ESM was different. That permanent mechanism should play the role of debt reorganisation platform, combining the Paris Club responsibility and requirements (private sector involvement) with financial possibilities of the EMU creditors and financial capacity of the IMF²¹. The ESM will swallow the costs of debt reorganisations within the EMU and assume the tasks that are currently performed by the EFSM and EFSF. The Treaty²² of the ESM must be accepted by the Parliaments of all participating countries, which would make the system more robust and operational from the budgetary point of view. The participating countries will not be forced to accept on *ad hoc* basis (with all the political impediments) the costs of rescuing the endangered economies and the eventual debt restructuring and reduction. The ESM will provide the rescue team the possibility to save euro as the world reserve currency and preserve the EMU as one uniform economic organism ready to compete on the world market. But the future of the EMU depends on the amount of resources available to the ESM and the formal possibilities for a swift and appropriate response to the evolving uncertainty, risk and eventually crisis. If markets do not believe in the efficacy of the ESM, the indebted economies will be not allowed to re-enter the financial markets at reasonable costs in the future. It is a dangerous issue in the present debt reorganisation process. Thus we already can observe different remarks about the ESM's capacity to manage the debt.

For the time being, the capital of over EUR 500 billion (the remaining funds of the European Financial Stability Facility) plus EUR 240 billion IMF has already raised should be sufficient to restructure Spanish, Italian, Irish and Portuguese debt due in the next two to three years to the foreign banks only²³. This means that the debt due to the national institutions should be rolled over by those respective national banks. This is a strong assumption, which implies the funding possibilities of the banking sector, so far delivered only by the ECB²⁴. Certainly, the ESM must also be operational as scheduled. All this creates pressure to further increase the financial resistance of the fund. Although there are possibilities of increasing the ESM credit capacity in the future (article 10 of the Treaty), one has to remember that the ESM will be financially 4 times more powerful than the yearly budgets of the EU²⁵.

²¹ Augmented in April by 430 billion USD with the EMU participation of 150 billion euro.

²² <http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf>

²³ USA and Canada said recently no for further firewall monies for the EMU.

²⁴ In March 2012, loans from the ECB to Spanish banks rose to 31.3 billion euros and almost doubled the amount of borrowings in February.

²⁵ Blocking voting power in the ESM was admitted to Germany, France and Italy. Consequently with the establishment of the ESM, the European Union members will be divided into three groups: members of the EU, members of the EMU and members of the Steering Committee of the ESM.

Therefore the most important prerequisite for success of the EMU mission is a real and quick transformation of the economies of the indebted countries. It would be unreasonable to expect the core countries permanently to subsidise peripheral economies just for the sake of preserving the monetary union. If the troubled countries are not able to return to financial markets, the monetary union will cease to exist as it is today. So during the coming two to three years, the peripheral economies will struggle to regain equilibrium and the core economies will prepare to run under the different external and internal conditions.

In September 2012 some further issues about ESM were clarified. The constitutional court in Germany ratified the country's participation in the EMS. The court ruled that the German liability to the ESM must not exceed 190 billion euro without parliament's approval of both chambers of the German federal legislature, which must also approve the conditions attached to any loans. These conditions will greatly complicate EMU rescue politics in the future. The decision says also as follows "... the Bundestag, as the legislature, is also prohibited from establishing permanent mechanisms based on international treaties which are tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate". This harmonises with the 1993's decision of the Court which permits Germany to leave the Eurozone if it threatens the financial stability of the country. Although Germany lessened its resistance to the unconventional measures used by the ECB and the ESM some important safeguards were maintained. That should preserve the German position in determining conditions of refinancing banks and governments.

All this makes the debt trap we observe in the EMU not so easy to escape from even if we assume that the rescue process is extended in time. For over a year, the IMF pointed out in its analyses the conditions necessary for the individual developed countries to develop their sustainable finances. The requirements concern *inter alia* primary surpluses. They should be in the coming years at an average of at least four per cent p. a. That relates to all developed countries including all economies under the bailout programme. From that perspective, the system created within the EMU is not stable now and will be subject to new market assaults in the future²⁶, because many necessary decisions are difficult or even impossible to implement. If e.g. the public sector in Spain deleverages and the government cuts spending²⁷ and raises taxes, also Spanish households should deleverage (remember the real estate bubbles). But in order to meet the balance requirements of the macro proportions, at the same time net exports must rise and non-financial enterprises increase investment. That could be encouraged by the policy of internal devaluation when the wage increase is slower than the retain earnings growth. But if we look at the projections (AMECO) of Spanish macro data, not many of the

²⁶ Only Italy, according to AMECO, should in 2013 achieve primary surplus over 4 per cent.

²⁷ Spain has already decided to cut spending by 17%.

expected changes are present (investments are falling, and national savings remain unchanged). Additionally, if the required level of deflation reduces further internal demand and GDP growth the debt/GDP ratio will worsen (according to the IMF, in the coming three years by 8.4 percentage points)²⁸ that will increase instability. Similar relations should be observed in Portugal and Greece. Ireland and Italy are different, but still their budget deficits do not confirm fiscal sustainability.

The similar problems arise in the current account. In the peripheral countries, we find net exports in the period 2008-2012 bigger on average than the real growth of GDP (according to OECD) when in 1999-2007 net exports reduced the GDP growth rate. It suggests that the current account can add to the growth of GDP. However, we can also find studies [Felipe, Kumar, 2011] showing that the share of exports of the peripheral countries (excluding Belgium) for respectively 10 and 100 of the most comprehensive, complex products in world exports was on average in 2001-2007 at a low level, amounting respectively to 2.94 per cent and 4.81 per cent. In the central countries, the respective share amounted to 24.68 per cent and 27.77 per cent. The least complex products (dividing the whole world exports in six groups) constitute in Greece 33 per cent of the total exports of the country (more than in China). In other words, increasing the share of the exports of the peripheral countries in the world exports will require such a level of deflation, which will slow the domestic demand less than the expected increase in exports, which seems hardly possible. In April 2012 European Economist Analyst Goldman Sachs estimated relative price adjustment needed to achieve external sustainability measured by the ratio of net international investment position to GDP [Nielsen, 2012]. For Portugal it was 35%, Greece 30%, Spain and France 20%, Italy 15%. On the other hand Germany's requires 25% appreciation which is supposed to be brought about by above-trend output growth driving inflation well above 2 per cent for a sustained period of time (more than 4 per cent for five to ten years in their simulation).

The present situation in EMU complicates additional budget needs resulting from social obligations: pensions and health care requirements (age-related costs). That is what the IMF pointed to as intertemporal obligations, consequences of an aging society and the social contracts once established (pension and health security in almost all developed countries). All the debts formally and socially contracted and incurred up to now should be paid by growing public contributions, in the form of taxes if one-off income or stock-flow is not possible. That calls for GDP growth. And here we are back to the already mentioned relationship; GDP growth can be achieved, assuming the public sector deleverages, if domestic absorption falls but the current account improves adequately. To achieve current account surplus (let assume that private consumption falls) the private non-financial sector in EMU will have to increase its debt. If export elasticity is low, then that pattern could lead to a new credit

²⁸ IMF <http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/download.aspx>

systemic crisis, building up instability at a higher level of overall indebtedness of all sectors.

If the intertemporal primary gaps are not closed on some of their off-balance sheets obligations [Haune et al., 2007] governments will renege. What form this default will take is difficult to judge. But that seems to be inevitable as on the basis of the current policies most public sectors in the EU are in a negative equity situation. The present and publicly forecasted relations between growth, budget deficits, inherited debt level and the implicit interest rate violate the transversality condition [Chalk & Hemming, 2000]²⁹. These predictions, if plausible, present the real challenge to the core countries which now defend euro while trying to convince the financial markets in the resistance and prosperity of the EMU. That problem is intertwined with a moral hazard dilemma connected with divergent states of the economies more and more visible now in the EMU. In the past 12 years, the central countries accumulated more net financial assets, while the peripheral countries accumulated more net financial liabilities. The poor became poorer and the wealthy became richer. It now makes the whole process of the debt reorganisation much more complicated and unpredictable. The peripheral countries have to defend what they gained up to the crisis of 2008 and what is left after the financial crisis eliminated some of those gains. In these circumstances, the EU austerity measures must create social and political tensions. There are tensions between the creditors and the debtor as well as within these countries. It already is changing the political scene in the EU and further threatens with growing social unrests as the prescribed by the creditors measures guide these countries out of the economic and social balance. Just as the labour union resistance and democracy turned out to be incompatible with the priority for the gold standard in XX century [Rodrik, 2011], so now similar factors can also be incompatible with the priority for the single common currency. Ambrose Evans-Pritchard of London's Daily Telegraph put it that way: "Democracies will make or break the back of the euro" [Barnes, 2012].

There is also another aspect of moral hazard. The ECB cannot increase liquidity forever. The share of the ECB assets in the EMU's GDP, which amounted to 17 per cent in December 2007, increased to approx. 30 per cent already by September 2012. That compares to respective ratios in the USA of to 6 per cent and 19 per cent, 7 per cent and 21 per cent in Great Britain, 22 per cent and 30 per cent in Japan. At some point, the ECB should unwind its instruments while sterilising the markets and selling the assets acquired during the intervention. Unless the Treaty on European Union and the Treaty on the Functioning of the European Union and the Statute of the ECB are amended, any losses incurred by the ECB in unwinding their positions should be covered by additional public money. One can envisage that the ECB to sterilise the markets will issue the Eurobonds, but that requires vital changes of the principles, on which the EMU was created.

²⁹ The transversality condition constrains the debt to grow no faster than the interest rate.

Finally, the debt reorganisation system established now in the EMU does not address comparability of treatment problem, which will surface in the not too distant future. As it was always in the past, the private and public debt was treated in the comparable way. So it was in the relations between Paris and London Club. Accordingly, it will be also in this case. With the passage of time, all remaining parts of the up to now unreduced debt of Greece will be held in the public hands of the SFV (ESM), the ECB or the IMF. It is difficult to judge how these liabilities will be treated as to make public debt reorganisation compatible with the private debt reduction. That relates also to the composition of the ESM. The construction of the ESM was proposed in a way, which *de facto* augments the comparability of treatment's problem, regardless of whether the weakest economies leave the EMU or not. Within the shareholders of the ESM, there are after all countries, which will be the net recipients of the financial resources invested by the ESM. Losses of the ESM will have to be distributed among the shareholders of the ESM [Beetsma, 2010]. How these costs of the debt reorganisations are to be divided between other members is not decided yet.

Conclusions

The debt management decisions taken following the financial crisis of 2007 and 2010 altered the macroeconomic relationship in a way, which increased susceptibility to external shocks in the most indebted economies. The growing debt/GDP ratio and persistent budget deficits presented in the official financial planning in all heavily indebted countries indicate that closing budgetary gaps will depend on deep structural changes. It takes time and external support as some important structural instruments are not available in the EMU. The needed deleverage cannot happen overnight and the so-called internal devaluation is socially painful and requires long political as well economic procedures. Because growth in the EMU, especially in the peripheral countries, still depends on the accessibility to the credit, therefore the ESM must get all possible support to settle the EMU debt problems as soon as possible. Without the final debt settlement the macroeconomic performance necessary to stabilise markets are beyond the reach of individual indebted countries. Consequently, the ESM created out of crisis necessities should also be perceived as an evolutionary method of transforming the EMU into a more fiscally integrated organisation. That requires the cooperation not only between peripheral and central countries but particularly within the latter group. Otherwise the ESM will perish together with the EMU. The new September unconventional action of the ECB stabilises for some time market volatility. But for the time being the ESM and ECB tackle only the debt level. The structural changes are left for individual countries to handle. That would be a difficult task to accomplish without the access to the world financial markets. On the other hand, to begin anew extensively crediting the already highly indebted economy could create fresh seeds of non-stationary systemic risk. To avoid that possibility Europe requires better than

it was before 2010 collective supervision of the financial markets. And should start examine the minimum requirements for the stabilization mechanism as a support of a common currency.

We believe that the ESM is the last attempt of the monetary union countries to keep the EMU functioning at the world market and let euro operate as a world reserve currency. These are highly regarded merits especially for the central Eurozone countries. So as long as the cost of disintegration of the EMU will be higher than the costs, the core countries expect to bear outside the EMU in order to maintain their internal equilibrium (employment and inflation) and growth, then during coming two to three years the ESM will be financially supported by the core economies. What will happen later depends mainly on the progress peripheral countries can achieve in restructuring their economies. So the biggest unknown relates to the uncertainty associated with the ability of these countries to regain credibility. There is also another important unknown relating to the political ability and possibility of the biggest and most resilient economies to cooperate directly outside the structure of the EU, as the European Commission can barely play the administratively supportive role. If the above mentioned conditions are not present, then the growing public debt of most of the EMU countries will create non-stationary systemic risk. Then the whole European Monetary Union will be shocked, exact timing being still quite unpredictable. We can infer that scenario from the past development of the debt negotiations and from the nature of the participating parties as it is obvious that all sides involved themselves in the non-cooperative game, which won't be repeated, as we already suggested.

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TRWAŁOŚĆ UGiW ZALEŻY OD POWODZENIA EMS W ROZWIĄZANIU KRYZYSU ZADŁUŻENIOWEGO

Streszczenie

Artykuł przedstawia źródła systemowego kryzysu zadłużeniowego w strefie euro. Charakterystyka prowadzenia polityki monetarnej w strefie euro wraz z nieefektywną polityką zarządzania długiem, zarówno sektora publicznego jak i prywatnego, powodowały narastanie w ubiegłym dziesięcioleciu systemowego ryzyka. W 2010 roku rynek kapitałowy odkrył popełnione w strefie euro błędy, wywołując kryzys zadłużeniowy. Analiza danych historycznych dla krajów strefy euro, prognozy makroekonomiczne sporządzane w Unii Europejskiej czy w organizacjach międzynarodowych, w połączeniu z obserwacją dynamiki prowadzonych negocjacji zadłużeniowych, prowadzą do następujących wniosków. Europejski Mechanizm Stabilizacji oraz Europejski Bank Centralny, jeżeli będą funkcjonować w sposób elastyczny, są w stanie w najbliższym okresie stabilizować sytuację zadłużeniową. To wymaga jednak ścisłej współpracy pomiędzy krajami peryferyjnym, krajami centrum jak również uzgodnień w ramach tych koalicji. Jest to warunek konieczny, lecz nie wystarczający dla stabilizacji strefy euro. Ponieważ większość krajów strefy jest wysoko zadłużona (co dotyczy nie tylko długu publicznego, lecz także prywatnego), potrzebne jest stworzenie nowego systemu regulacji sektora finansowego wspieranego działaniami, instrumentami które pozwolą krajom peryferyjnym „wyrosnąć z długów”. Do rozwiązania kwestii zadłużenia i do powrotu krajów peryferyjnych na rynek kapitałowy potrzebne będzie częściowa redukcja długu (w bezpośredniej czy pośredniej formie) oraz zewnętrzne wsparcie dla prowadzonych reform. Wysoko zadłużone kraje peryferyjne nie są bowiem w stanie same, z powodów ekonomicznych i politycznych, w krótkim czasie, wdrożyć niezbędne programy dostosowawcze. Jak we wszystkich poprzednich negocjacjach zadłużeniowych kwestie moral hazard, porównywalności traktowania wierzycieli i dłużników oraz warunkowości udzielanej pomocy będą odgrywały rosnącą rolę.

Słowa kluczowe: dług, zarządzanie długiem, stabilność finansowa, Unia Gospodarcza i Walutowa, Europejski Mechanizm Stabilizacyjny

Kody JEL: F34, G15, G18, H63, H68
