CEPS COMMENTARY
Thinking ahead for Europe

Financial Stability: 'Collective responsibility' will not work

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Is the 'euro crisis' closer to a resolution? Europe's leaders have promised to find by the end of this month a comprehensive package, not only to end this crisis, but also to preserve the stability of the euro for the future. Unfortunately they are unlikely to succeed because most of the elements of the package on the table so far deal with the symptoms, not the underlying cause of the crisis.

Chancellor Merkel likes to underline, rightly, that one should not speak of a 'euro crisis', but of a 'debt crisis'. If she had added that this is a crisis of both sovereign and bank debt, she would have been even more right. But an immediate corollary of this diagnosis is that to deal with this crisis one would have to find a solution for the debt problem, i.e. the problem of over-indebted sovereigns and insolvent banks. Unfortunately nothing is being done on these crucial aspects. The new complex mechanisms for economic policy coordination that dominate the EU's agenda might be useful to push euro area member countries to adopt more sensible policies, making their economies more competitive and their fiscal positions stronger. But one should not forget that until recently Ireland and to some extent Spain were held up as the shining examples of competitive economies that created a record number of jobs. It is thus doubtful that tighter economic policy coordination will prevent new bubbles from emerging. When powerful booms emerge in different sectors, the temptation to argue that 'this time is different' will again be irresistible.

Financial markets at any rate do not care much about the future set-up for economic policy coordination in the eurozone. They need to know how the existing debt overhang will be dealt with today. But why should a debt problem in economies that are usually called 'peripheral' be so important for financial markets? Greece and Ireland, even taken together, account not even for 5% of the economy of the euro area. Their problems would not constitute a major issue if Europe's financial system were robust. A peripheral debt crisis has mutated into a systemic crisis because the financial system of the euro area is too interconnected and too weak.

Given the interconnectedness of financial markets in a common currency area, weakness in any one corner spills over into the entire system, which cannot be stabilised until all of its major components have been dealt with. But Europe lacks a common body that has the fiscal resources to stabilise the system as a whole. The required fiscal resources exist at the national level, but their use is generally guided by purely national considerations and interests. In other words: Europe faces a fundamental collective action problem.

Experience has shown that it takes an acute crisis to force Europe's leaders to come together in a concerted effort. But so far nothing has been done to address the fundamental problem that there is no common body to look after the stability of the entire financial system.

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In the autumn of 2008, at the height of the global financial crisis, the heads of state of the euro area did not consider the creation of a common bank rescue fund. Instead they settled for a package of national measures to stabilise national banking systems one by one. The sum of the headline commitment was impressive, amounting to 20% of GDP. However, the show of unity did not last long. Execution of the package was rather uneven, with some countries ending up not doing anything. The key areas of weakness in Europe's financial markets, which include undercapitalised banks in core countries, were thus not addressed, and the system was not able to withstand the second wave of the crisis: the peripheral debt crisis.

The Greek and Irish crises were initially greeted with disbelief. The official line until the very end was that both countries might be in a tough situation, but they were on the right track and if only financial markets would give them credit there would be no problem.

However, when investors entered a buyers' strike (and depositors started to flee from Irish banks), Europe's leaders were moved to grant both countries new lines of credit. Since the European Council of February 2010, the guiding principle has been that safeguarding financial stability is a 'collective responsibility'.1

At the highest political level this was meant to signal that the European Council would do 'whatever it takes' to stabilize the euro. In practice, however, the kind of 'collective responsibility' that has actually been implemented does not solve the collective action problem because the underlying assumption has been that the entire system would be stable if every national banking system was stabilized. This is clearly not the case, however, because every national authority will just expend the minimum in effort to stabilize its own national banks, assuming that the rest of the system is in good shape.

This is why very little has been done so far to strengthen the ability of the financial system to withstand a default of any magnitude. The only attempt in this direction was the publication, in July of 2010, of the results of the stress tests on over 90 of the EU's largest banks. But this episode showed once more what one has to expect when there is no EU-wide body to look after systemic stability. Every national supervisor has an incentive to find that 'our banks are safe', even if many institutions are only thinly capitalised and thus contribute to the fragility of the system as a whole.

The degree to which this was true became apparent in November 2010, when it emerged that essentially the entire Irish banking system, which had received a clean bill of health no longer ago than June, was bankrupt – and the market decided that this might apply also to the Irish government, which then had to be bailed out by the European Financial Stability Facility (EFSF).

The 'euro crisis' can thus end only if the euro's financial system were strengthened so that debt problems in the European periphery no longer threatened the stability of the system as a whole. This will require a number of elements, such as higher capital requirements on sovereign debt, real stress-testing and enlarging the mandate of the EFSF so that it could also recapitalise banks, and not just bail out countries. Ensuring systemic financial stability is the order of the day. That, rather than elaborate mechanisms for economic-policy coordination or grand designs for competitiveness, should be at the top of the European Council's agenda.

[1] See Statement by the Heads of State or Government of the EU, 11 February 2010 (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/112856.pdf).