

The politics of the Eurocrisis

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The Eurocrisis began in 2007-8 as a banking crisis (stage 1); it was followed by economic recession (stage 2); and subsequently it turned into a sovereign debt crisis (stage 3), which has the potential to generate a new banking crisis. Whereas some countries, such as the UK and Ireland, were badly hit by the first phase of the crisis (banking crisis), others, such as Italy and Greece, were moderately affected by the banking crisis, but were severely affected by the third stage of the crisis, which involved severe difficulties in financing sovereign debt. At risk are also continental countries whose banks have most heavily invested in government bonds of the countries at risk of default. The causes of the first stage of the crisis, the banking crisis, and the response of the European Union (EU) were discussed in a previous issue of Euroscope. Here the focus is on the third stage, the sovereign debt crisis, which kicked off in in early 2010 and was caused by a variety of factors, as explained by Peter Holmes's contribution.

The EU response to the sovereign debt crisis was ad hoc and feeble. As a consequence of the crisis, the ECB has necessarily paid more attention than it the past to the objective of safeguarding financial stability and taken some unconventional measures. Initially, with some reluctance, the ECB engaged in targeted purchases of bonds of

countries at risk of default in the secondary markets. In December 2011 the ECB has taken measures designed to ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market with a view to support the provision of credit to households and non-financial corporations.

Prior to the crisis there were no specific EU mechanisms to deal with crisis situations and this shortcoming was only partly addressed by the stabilization funds/mechanisms set up in the midst of the crisis. The European Financial Stabilisation Mechanism (EFSM) was set up by the Council of the EU in May 2010 as an emergency funding programme for all EU member states in economic difficulty, subject to conditionality. Funds are raised on the financial markets by the European Commission and guaranteed by EU budget. It has the ability to raise up to €60 billion. The European Financial Stability Facility (EFSF) was also created by the euro area member states in May 2010. It can issue bonds, guaranteed for up to € 440 billion for on-lending to euro area Member States in difficulty, subject to conditionality. Issues are guaranteed by the euro area Member States. It may intervene in the debt primary market and is to be liquidated by 2013. The European Stability Mechanism (ESM) was agreed by the Council in March 2011. It provides financial assistance, under conditionality, to euro area Member States. It may also intervene in the debt primary market. It will assume the role of the EFSF and the EFSM in providing external financial assistance to euro area Member States after June 2013. The ESM will have a total subscribed capital of € 700 bn, with € 80 bn in the form of paid-in capital provided by the euro area Member States from 2013 onwards and guarantees from euro area Member States to a total amount of € 620 billion. The meeting of the European Council on 8-9 December 2011 decided to bring forward the coming into force of the ESM.

Prior to the crisis, the mechanisms for fiscal policy coordination in the EU were weak and they were only partly strengthened by the EU decisions to enhance the Stability and Growth Pact, the new macro-economic imbalances procedure, and the Euro Plus Pact. On 8-9 December 2011 the European Council decided to establish a 'new fiscal compact' – a European fiscal rule to be transposed in national legislation (see Jim Rollo's contribution).

Overall, the EU response to the crisis has so far been constrained by German emphasis on the competitiveness and sovereign debt problems of the Euro Area as long-term problems that require mechanisms to buy time for painful domestic adjustments in line with retaining the integrity of the Maastricht monetary constitution, especially the no bail out clause and the principle of separation of fiscal and monetary policies. In this context it has proved impossible to progress proposals for Eurobonds and, above all, for a lender of last resort other than to the banking system. in the EU or in the Euroarea and there is not an equivalent of an EU treasury. At the core of the politics of the Eurocrisis there is a division within the EU between fiscally 'sinning' countries (namely debtor countries) and fiscally 'virtuous' countries (namely, creditor countries), as explained by Alan Mayhew's contribution. The EU is also plagued by large intra-EU macroeconomic imbalances, whereby creditor countries have surpluses in the balance of payments, and debtor countries have deficits. This division between debtors and creditors creates a moral hazard problem and a collective action problem: the basic question is who should bear the costs of adjustment (Dyson and Quaglia 2010). So far the EU has not found a convincing answer.

Dyson, K., Quaglia, L. (2010) *European Economic Governance and Policies. Volume II: Commentary on Key Policy Documents*, OUP