European Shadow Financial Regulatory Committee

Increasing Fragilities in the Eurozone: Time for Decisive Action

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The world is facing unprecedented times. After the shock of the corona crisis during 2020-2021 we are now confronted with the consequences of the war in Ukraine. Energy and food prices have been rising dramatically, leading to inflation rates which we have not seen in Europe since the oil crises in the 1970s.

Last week the Governing Council of the European Central Bank (ECB) met in Amsterdam and announced that it would start raising interest rates for the first time since 2011 in order to combat inflation. Moreover, the ECB decided that it would stop net purchases of government debt of Eurozone countries.

In its statement in February 2020, the European Shadow Financial Regulatory Committee (ESFRC) argued that the Eurozone is still facing huge fragilities, which may threaten the survival of the Euro, notwithstanding the important measures which were taken after the banking crisis of 2007-2009 and the Eurozone crisis of 2010-2012. These measures included the recapitalization of banks, the launch of a Banking Union, unprecedented liquidity support through the ECB and emergency loans to several countries in the Eurozone.

Unfortunately, the corona crisis has increased the government debt ratios of most Eurozone countries further. Inflation has gone up substantially due to disturbances in the global supply chain after the corona crisis and the rise of energy and food prices caused by the war in Ukraine. Monetary policy is tightening to reduce inflation. Long-term interest rates have already risen substantially, fuelling worries about the sustainability of government debt of Eurozone countries. Countries with high debt ratios, notably Greece and Italy, risk premia on their government debt have been subject to further increases of risk premia on their government debt compared to Germany.

In order to prevent escalation of the current potentially explosive situation in the Eurozone the ESFRC recommends to take decisive action on the following points:

1. The design of a longer term financial policy action and structural reforms for highly indebted countries, such as Italy and Greece, where low economic growth and rising government debt ratios put the countries at risk of facing a financial sustainability crisis. This might lead to huge losses for banks and and other investors in their government debt, a European banking crisis and an exit from the Euro with unforeseeable consequences for the whole EU.

In this respect we now advocate the activation, for the first time, of the policy of Outright Monetary Transactions (OMT) under which the ECB can purchase short-term government bonds of countries such as Italy and Greece under the condition that these countries can reach a Memorandum of Understanding on economic reforms and budgetary policy with the European Stability Mechanism (ESM).

This Memorandum of Understanding on economic reforms and budgetary policy should follow the rules and substance of the Stability and Growth Pact (SGP), notwithstanding the temporary deactivation of the SGP, first due to the corona crisis and currently because of the war in Ukraine.

2. After agreement on a credible action plan for countries such as Italy and Greece, policymakers should move towards completing the Banking Union by introducing a European deposit insurance scheme (EDIS).

   Without an EDIS, depositor protection remains dependent on bank location and on national deposit insurance schemes. This will distort the level playing field.

   Clearly, the resasons in favour of an EDIS crisis were already relevant before the corona crisis, but they have become particularly important now given the increasing fragilities in the Eurozone. EDIS would reduce the likelihood of bank runs through a confidence-enhancing mechanism, thus avoiding potential vicious spirals that aggravate negative shocks in individual EU countries.

3. European bank supervisors should increase macro-prudential capital buffers for banks given the increasing risks and uncertainties facing the Eurozone.

4. To prevent government debt ratios of Eurozone countries to increase further, thereby putting debt sustainability at further risk, the EU should finance its ambitious agenda of investments in climate, sustainability and digitalization through pan-European investment funds.

   The pan-European NextGenerationEU recovery and investment fund, which was created at the beginning of the corona crisis in 2020, is already providing funds for investments in climate, sustainability and digitalization. However, more funds may need to be committed during the next decade.

   These pan-European funds are financed by the EU issuing new bonds on European capital markets (instead of national governments issuing bonds). Investors are likely to see the issuance of European bonds as a signal of commitment to the Euro, thereby lowering expected risk premia on sovereign debt of Eurozone countries.

   Moreover, the issuance of bonds is a mechanism of strengthening the fiscal pillar of Economic and Monetary Union (EMU), relieving monetary policy from tasks for which it is not well-suited and enabling the ECB to focus more on its primary mandate of price stability.

The European Shadow Financial Regulatory Committee acknowledges in deep gratitude and in living memory the life and work of Professor Clas Wihlborg, one of the founding members of the ESFRC, who sadly passed away in March 2021.