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A COMPREHENSIVE APPROACH TO THE EURO-AREA DEBT CRISIS

by

3. Like many countries the Greek state has assets, including significant holdings of land. These could potentially serve as collateral to guarantee loans but even a major divestiture of public property would be insufficient to

5. We only consider here

countries would remain limited. The fear of a domino effect is understandable, but exaggerated.

Table 2 also shows that spillover effects from crises in other countries are clearly different. The exposure of euro-area banks to

8. See Darvas *a* (2011) for details.

and credible stress tests is therefore an absolute priority for the euro area. Because EU banking supervisors squandered credibility in the previous round of stress tests, we advocate involving the IMF and possibly the Bank for International Settlements, in the next round of tests. We suggest that the March 2011 European Council adopts the necessary measures to ensure that the forthcoming stress tests be as rigorous and credible as possible.

Once such tests have been carried out, euro-area countries must proceed immediately with bank restructuring where necessary, which should imply the recapitalisation of viable institutions and the closure of non-viable ones. To this end, EFSF funding should be made available to governments.

The restructuring of some banks in core countries is likely to be necessary, especially if bank losses turn out to be significant in Spain, the only peripheral country where restructuring would, according to our estimates, have a significant spillover effect on the rest of the euro area.

Bank restructuring would be accelerated if EU countries were to introduce special bank resolution mechanisms in their domestic legislation, as proposed by the European Commission. In line with the February 2011 German proposal[9], we advocate that heads of state and government agree in March to put in place such mechanisms without delay. But beyond national efforts, there is a strong rationale for the creation of a temporary 'European Bank Treuhand' (Posen and Véron, 2009), to catalyse recapitalisation and manage any distressed assets that may fall into public ownership, while keeping fiscal outlays in national hands.

Beyond the immediate short term, there is an obvious need to put in place a solid European banking supervision and resolution framework. One lesson from the crisis is that such a framework must go beyond coordination between national institutions. Nothing less than supranational banking supervision and resolution bodies can handle the kind of financial interdependence that now exists in Europe. Ideally, such bodies should cover all EU countries, since they all belong to a single financial market. However, in case this proves to be politically unrealistic, euro-area countries should create their own institutions.

Before the crisis, the creation of

9. See, for example, the *F a c a T* of 3 February 2011, 'Eurozone members are negotiating a "grand bargain" to tackle the bloc's debt crisis'.

banks) and because of the seniority issue. Currently, bilateral government loans and EFSF loans do not enjoy formal seniority status. Yet it would be unthinkable to bail in those EU members who came to the rescue of their ailing partners, especially since the IMF, which provided parallel loans, enjoys senior creditor status. If formal restructuring is needed, we advocate that it takes inspiration from the mechanism presented in Gianviti *a* (2010).

In both cases, the burden of adjustment should not fall only on private bondholders. First, investors should whichvv85Her12.2(e)78(o)15 a variT7W5xTJT G[(t)23.9(h)17.1(14.se s1(s)18.1(pio)15e)7.8(s)6 i6i4 Bsd whi(n), enadrhanis4202571 TD(u)17.1(s)6.9(t)0(m)13 0I27(e)0rnly 96TD-0.00W.8(s)1eizsä1(e m)123(at i0(v))61bhenler investors shoulthinkable0(m)19.1(1(pio)15e25.9f.2(15 a variT7T*0.02)30.8(atio)15.2(n f)6.(.1(u(pio)1p.0524 (r)0(s)60*0.0981.

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budget. The discussion on the next 2014-20 multiannual financial framework is an opportunity for fresh thinking about new ways to foster investment in the four countries and other crisis-affected countries, especially in central and eastern Europe.

CONCLUSION

For several weeks there has been an expectation among political observers and market participants that the March European Council will deliver measures amounting to a comprehensive solution to the euro-area crisis. This expectation was reinforced by the 4 February 2011 European Council, where euro-area heads of state and government announced their intention to finalise in March a 'comprehensive strategy to preserve financial stability'.

We argue that a comprehensive approach must start by recognising two basic facts. First, peripheral countries face a huge challenge in adjusting their weak economies and avoiding a vicious circle of high private and public debt and low growth. Second, banks and fostering adjustment and growth in peripheral countries through budgetary consolidation and competitiveness-enhancing measures, and through mobilisation and better implementation of EU structural funds.

Too much time has been lost, too much confidence has been dented and too much credibility has been squandered in the past year. Building on important decisions already taken, EU leaders should move decisively and agree on a comprehensive package along these lines at the March 2011 summit. This would be a major contribution to the cohesion and the revival of the euro area.

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