Shadow Financial Regulatory Committees of Asia, Australia - New Zealand, Europe, Japan, Latin America and United States

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The Eurozone Crisis: A Roadmap for Urgent and Decisive Action

While European leaders have been meeting in Brussels to address the crisis in the eurozone, our six Shadow Financial Regulatory Committees have been meeting in Washington to consider lessons from the recent global financial crisis. We believe that there are important lessons from that crisis for providing a framework for assessing the plans for resolving the current European crisis.

One of the central lessons of the recent global financial crisis, and other financial crises that have plagued the world the past decades, is that failing to recognize and credibly allocate losses does not make them go away. Rather, delayed action exacerbates market uncertainty about who will lose and how much, which worsens and prolongs market reactions to losses. For example, in 2007 and 2008, US and EU policy makers failed to resolve losses in financial intermediaries, even though those problems were apparent and recognized by markets. By waiting to act or recognize and allocate losses, policy makers aggravated uncertainty and were forced to respond reactively to the collapse in market confidence in the fall of 2008, which greatly enlarged the economic and social costs of the crisis.

Europe now faces a three-dimensional crisis: (1) debt sustainability problems of sovereigns, (2) bank solvency or capital inadequacy problems, and (3) differential competitiveness across countries of the eurozone (over- or under-valuation of real exchange rates within the eurozone). These problems are interrelated and the weights attached to each of them vary across countries within Europe. There is an urgent need for Europe to respond to these problems decisively. We acknowledge that this is hard, since there is no easy and painless way out. The necessary decisions that must be made will entail substantial costs over several years.

European policy makers must bear in mind that when short-term interventions are announced, market participants will be looking for credible commitments that ensure long-term sustainability of whatever plans are presented. This requires mechanisms for restoring sovereign solvency, confidence in banks, and competitiveness for troubled eurozone members. The ingredients of such a program include the recognition and allocation of existing losses, as well as reforms of fiscal policy, improvements in financial regulation, and growth-enhancing measures.
In order to address these problems quickly and effectively, Europe must undertake a four-stage plan for dealing with its crisis.

First, Greece – which is the most obviously troubled and fiscally unsustainable country within the eurozone – must restructure its debt to a sustainable level. While assisting Greece to restructure in an orderly fashion and restore growth, European leaders must ensure that the rest of Europe is successfully protected from any contagion to other countries' banks and sovereign debts that could accompany Greek restructuring. A successful response requires the agreement and articulation of a plan for allocating losses related to Greece in a way that prevents the contagion that results from a lack of a credible plan.

Second, as part of a broader, credible and transparent formula for recognition of losses and loss allocation, European governments must ensure that banks will be adequately capitalized to restore market confidence in the financial system. This means that banks that are currently exposed to potentially large losses must be sufficiently strong to avoid insolvency risk, or protected by government guarantees, or resolved with clear implications for their claimants, or re-capitalized, either with private or public funds. Tougher choices about bank resolution are now required because prior bailouts have significantly weakened public finances.

Third, sufficient funding must be available from a coordinated, large, and credible source to eliminate uncertainty about the sustainability of European sovereign debts. This also entails the recognition and allocation of losses, either explicitly or implicitly, and the provision of sufficient liquidity support. For example, the European Central Bank (ECB), European sovereigns, the IMF, or some other international consortium, could provide sufficient support for some or all sovereign debts. Funds from such a facility could be made available either without preconditions or only to qualifying countries that have passed sufficient reforms. All of these arrangements would be examples of coordinated, large, and credible plans for resolving sovereign debt uncertainty, each of which would imply effective taxes and transfers among various countries' taxpayers. Thus far, although the European Financial Stability Fund (EFSF) and ECB have provided some support to sovereigns, that support has been insufficient to resolve market uncertainty. We note, of course, that support from the ECB without credible commitments on the part of ECB member countries to absorb the fiscal consequences of ECB purchases, might result in a significant inflation tax.

Fourth, a sustainable long-run path for the current members of the eurozone must address long-run competiveness problems related to current real exchange rate misalignments. Southern European countries' real exchange rates are currently substantially over-valued relative to the north. There are three obvious ways to correct this problem.

One approach – a passive strategy – would simply envision a painful deflationary adjustment of prices and wages in the south over several years. This approach entails costs of slow growth, high unemployment, and potential political unrest, all of which could undermine necessary fiscal consolidation. This approach may prove unsuccessful, and therefore, result in little gain at great cost.

A second strategy would be for some countries to leave the eurozone immediately. This would be disruptive to markets, and could undermine confidence in European institutions and the commitment to integration.

A third possibility would be to ease the adjustment process toward reestablishing competitiveness by engineering a higher inflation rate for several years in the eurozone. This would impose an inflation tax on the north, while easing the deflationary adjustment in the south. This adjustment would still require deep structural reforms in the south to prevent future misalignments of real exchange rates. To make these reforms credible, it might be necessary to reform governance structures within the eurozone and the EU.

Regardless of which of these options for the eurozone is chosen, it is vital that international bank regulation be fundamentally changed because the bank capital standards set by the Basel Committee and in place since 1989 contributed importantly to the crisis. As the incoming ECB President, Mario Draghi, recognized in a speech in Brussels in May, "the existence of loopholes [in the Basel framework] because of lack of coordination or consistency was indeed one of the major factors of the crisis." Both the Basel I and II standards artificially induced European banks to purchase excessive quantities of sovereign debt, which the standards assigned a zero risk weight, implying that banks had no requirement to back any of these purchases with owners' equity. In addition, because all government debt was assigned the same zero risk weight (as long as that debt was rated as "investment grade" by the ratings agencies), the banks had no incentive to discriminate in their holdings of the sovereign debt they did purchase or to diversify their holdings.

Although the Basel Committee revised the capital standards after the last crisis, and eventually will require banks to increase their capital, the Basel III standards contain the same defects as the earlier versions. In particular, the zero risk weights for sovereign debt continue.

The six Shadow Committees have been highly critical of the Basel standards over the years on multiple grounds, including their complexity and arbitrariness. We believe that the time has come to abandon the current Basel methods for setting capital standards and to substitute better standards, including a simple, but ample, minimum required leverage ratio – shareholders' equity divided by total assets.

The entire world has a stake in an urgent, credible resolution of the eurozone crisis and rectification of bank regulation. There are several channels of potential transmission of European problems to the rest of the world if this crisis is not satisfactorily addressed. Failure to fix the bank capital standards will continue to provide artificial incentives for banks to purchase sovereign debt, regardless of quality, and thereby sow the seeds for possible future crises.

If capital flees the weaker European economies, there is a great risk that it will also flee from emerging markets in general, and from countries with high debt-to-GDP ratios, especially those with short-term maturity profiles. This would lead to higher interest rates and credit contraction in all these markets. Indeed, there is an urgent need to bolster IMF resources in order to provide liquidity to emerging market economies that could be damaged by the fallout from a failed eurozone plan.

In Latin America, the negative impacts could be magnified by the fact that European banks account for a large share of the banking system. If European banks are adversely affected by the crisis in their home countries, there is a significant risk that they will transfer funds from their Latin American operations to their home country offices, thereby leading to a dangerous contraction of credit in Latin American economies.

The U.S. economy is exposed financially in a different way. Roughly 40% of U.S.-based money market mutual fund assets are invested in the short-term liabilities of European banks. If those banks cannot honor their obligations, they expose these money funds to "breaking the buck" and thus either potential runs, or yet another bailout as occurred after the Lehman failure in September 2008.

Worldwide investors are exposed through their equity investments in Europe. A crisis in Europe which resulted in a significant decline in European equity values could not only cause direct losses to shareholders in other economies, but trigger an equity crash in other markets.
Problems in Europe, if not properly addressed, could also severely interrupt trade finance, thereby cutting global trade. This outcome would be amplified by the substantial contraction in real activity in Europe that would cause a decline in exports from all countries now sending goods and services to Europe. Europe's largest trade partners – the United States, Asia (China and Japan included), and all commodity exporters – would suffer.

Furthermore, there are unknown exposures. For example, it may be difficult for regulators to know the extent of counterparty risks relating to various European financial instruments and financial institutions. In the United States in 2008, AIG was rescued in part because regulators feared it was excessively exposed to counterparties on its credit default swap contracts. Who knows if there are other potential AIGs out there in the event of a Eurozone crisis?
In sum, time is of the essence. Actions to address the European crisis in a credible sustained fashion are urgently needed, while bank capital regulation throughout the world must be fundamentally reformed.