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The eurozone must change its stability mechanism

The eurozone financial crisis has lasted so long and been managed so poorly because policy makers have disregarded some fundamental aspects of the way in which financial markets work. In fact, the euro was created under the assumption – or rather the illusion – that financial crises would never happen because markets would discipline member states' budgets. Furthermore, when the first problems emerged in Greece, the risk of contagion to other countries was ignored and the crisis was addressed in a piecemeal approach. Only when contagion became apparent and threatened the integrity of the eurozone was an agreement reached to create a safety net.

The creation of the new institutions was not straightforward because European policy makers wanted to innovate, by making financial assistance conditional on the involvement of private creditors, independent of the sustainability of the country's public finances, as is instead the case for International Monetary Fund assistance. While the aim of minimising taxpayers' money was certainly noble, the result turned out to be the opposite because the scheme did not take into account that market participants are forward looking. The prospects of automatic debt restructuring tend to scare away investors, even from sound debtors, especially in the midst of systemic crises. Indeed, the Deauville agreement between Germany's Angela Merkel and France's Nicolas Sarkozy, which was subsequently endorsed by all the other heads of government in mid-October 2010, fuelled new tensions and made the euro area more vulnerable. It was fortunately reversed in December 2010, under pressure from the European Central Bank.

That experience should have taught policy makers to be more careful in designing a bail-in and bail-out mechanism, with a view to avoiding putting the European financial and banking systems at a disadvantage compared to the rest of the world and thus penalising European taxpayers. Unfortunately, it does not seem that the lesson has been learnt. The recently agreed European Stability Mechanism direct bank recapitalisation instrument contains the same fault lines of the Deauville agreement.

It is surprising that this problem has not emerged yet in public. It is even more surprising that the heads of governments of the more vulnerable countries have signed up to it while it makes their countries' banking systems more fragile and further increases the correlation between sovereign and banking risk. It is thus detrimental to their taxpayers.

To understand where the problem lies, consider how the US authorities managed the post-Lehman Brothers consequences on the domestic banking system, in the autumn of 2008. While the US banking system was fundamentally solvent, according to the severe stress tests that had been conducted by the US supervisor, the contagion from the Lehman bankruptcy was putting at risk the stability of the entire financial system. To avoid a collapse, the system needed to be ring-fenced with additional capital buffers that would allow it to absorb substantial losses, in case they occurred. The US authorities used the proceeds of the Troubled Asset Relief Program, which was ultimately voted by Congress, to force banks temporarily to increase their capital basis, for as long as the crisis lasted.

This decisive action enabled the US banking system to withstand the contagion and avoid a drying up of market liquidity. When the worst of the crisis was over the US Treasury was fully reimbursed and taxpayers did not suffer any losses. The resilience of the banking system – thanks to public intervention – is one of the key factors which has contributed to a speedier and stronger recovery of the US economy, compared to the eurozone.

A similar action could not be implemented in the eurozone because the latter lacked a single regulator, in charge of assessing banks' capital adequacy and solvency in a credible way, and a single fiscal authority providing the backstop to contain the contagion effects.

The decision to move towards banking union, in the summer of 2012, was a key step to overcome one of the monetary union's shortcomings. The problem is that some of its features are badly designed. The configuration of the fiscal backstop – the ESM – is in fact so distorted as to increase the risks of contagion in case of a financial crisis. The eurozone policy makers have been hit by the Deauville syndrome again.

Indeed, the ESM instruments foresee that the mechanism can be used to directly recapitalise banks only subject to the bailing-in of shareholders and private creditors, according to the pecking order established in the forthcoming Bank Recovery and Resolution Directive. Such a provision is appropriate to address an individual bank's solvency problems. However, the solution becomes very problematic if the aim is to stop the contagion that can emerge from a specific shock, such as the bankruptcy of a bank, to the rest of the financial system.

Under such circumstance, as it happened in the post-Lehman US situation, the supervisor may consider it necessary that the whole banking system must rapidly raise capital, as a precautionary measure. If, under current ESM rules, such a capital injection can be implemented only if private creditors are also bailed-in, any suspicion about the solvency of a specific bank will immediately induce the creditors of other banks to withdraw their funds. Contagion would thus rise, instead of abating. Under such circumstances, the amount of capital needed, and thus the funds to be drawn from the ESM, would have to be much higher. The ECB and national central banks would face pressure to inundate the system with emergency liquidity.

The provisions included in the ESM instrument have been conceived to address individual bank problems, not systemic crises such as those we have experienced in the recent past, including after Lehman's bankruptcy. The likelihood that an individual crisis spreads to a systemic has increased.

We cannot wait for another crisis to find out that the new instrument has been ill-conceived. As for the Deauville agreement, the ESM needs to be changed to eliminate its perverse effects. In particular, the requirement for bailing-in private creditors should be excluded when the supervisor – ie, the ECB –considers it appropriate for the stability of the financial system.

Unless this is done, the burden for taxpayers will increase. Those that do not want to make the change should be accountable for it.

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