

# THE CRISIS MANAGEMENT FRAMEWORK: WHAT FOLLOWS AFTER EFSF AND THE EFSM?

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The near fiscal collapse of Greece last spring has triggered intense activity to prevent the fiscal crisis from intensifying and spreading more broadly across the euro area. This efforts lead to establishment of the European Financial Stability Mechanism (EFSM) on May 10 2010 and the European Financial Stability Facility (EFSF) on June 7.<sup>1</sup> The crisis has also triggered a discussion of how to strengthen the Stability and the Growth Pact (SGP), which to date has been the main institutional mechanism to reduce the likelihood and severity of a public debt crisis.<sup>2</sup> Furthermore and more importantly, the possibility of introducing an explicit Crisis Management Framework, which so far has been lacking, has received a great deal of attention. A specific issue in this context is what should come after, if anything, the EFSM and the EFSF, which will only be operative for a three-year period (although they may take some time to close after that).

This note has four sections. The first of these reviews some of the weaknesses of the SGP. Section 2 turns to the EFSM and the EFSF, and argues that the fact they are temporary is problematic since they may provide little incentive for government to change fiscal policy in a lasting way. Section 3 turns to what features a well-functioning regime for the resolution and management of crises must have. Section 4 makes some concrete suggestions for strengthening of the institutional framework and Section 5 concludes.

## 1. INSTITUTIONAL WEAKNESSES TO DATE

It is useful to start by briefly reviewing the reasons why the SPG proved ineffective in avoiding the crisis and why it is necessary to have a clear framework for the management of crises.

The purpose of the SPG was to avoid the risk of a fiscal crisis by preventing euro area governments from accumulating (too) large public debts. The historical record, as well as the most recent experience, indicates that if the public debt is large and growing, bond holders may become

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<sup>1</sup> [www.reuters.com/article/idUSTRE6490A820100510](http://www.reuters.com/article/idUSTRE6490A820100510) provides the text of the EU crisis mechanism agreement adopted of May 10, 2010.

<sup>2</sup> The ECB's views are presented in the document on "Reinforcing economic governance in the euro area" of 10 June 2010. See [www.ecb.int](http://www.ecb.int).

concerned that the government might not be able to service and repay it. In turn, this may lead them to hesitate to roll-over bonds when they mature, triggering a sovereign debt crisis.

While the intentions behind the SGP were thus correct, why wasn't it adhered to? Several factors appear to have played a role.

The main reason was a lack of commitment to the SGP by euro area governments. The root of this problem is the fact that decisions regarding government spending and taxation involve redistribution of income and wealth and are therefore intensely political. Governments do not wish these to be restricted and therefore strive to avoid being seen as interfering in each other's fiscal policy decisions in the hope of reciprocal treatment. This hesitancy to comment on violations of the SGP and to invoke the Excessive Deficit Procedure meant that there was little incentive for countries to adhere to the SGP. Moreover, since no European country has experienced a public debt crisis in recent decades, some governments no doubt remained unconvinced about the dangers of large public debts.

This lack of commitment to the Pact was largely due to design problems that rendered it ineffective. Several weaknesses are now evident.

- First, there was a lack of automaticity in the application of the excessive deficit procedure and the SGP relied too much on peer pressure. In a small group of countries interacting on a range of issues that generate ample opportunity for trading off different objectives, it was difficult to forge agreement about the need to enforce the rules.
- Second, the sanctions were too abrupt and therefore too punitive to be used. Consider a government that sees economic activity, and therefore tax revenues, grow below trend. If this pushes the budget deficit about the 3% limit, the SGP required the country to tighten fiscal policy at a time of economic weakness, exacerbating swings in the economy.

Of course, the solution to this problem is to strengthen the government's fiscal position in good times so that a large recession would not push the deficit beyond the 3% limit. But such long-term policies are unlikely to be adopted in a situation in which governments face short-term political pressures.

- Third, there was a lack of clarity about whether excessive deficits were due to bad policy or bad luck, which made it difficult to the peer pressure mechanism to operate.

Budget outcomes are volatile and largely determined by the state of the economy rather than changes in fiscal policy. Thus, business cycle contractions reduce tax collections and increase the pool eligible for unemployment benefits and income support. Governments could thus argue that budget deficits occurred despite their best efforts to adhere to the rules.

Furthermore, it is difficult to enforce the rules of the SGP since budget outcomes are only known with a lag. While this problem could be avoided by holding governments accountable by using deficits forecasts, these are sensitive to assumptions made about economic growth. The fact that recessions tend to be correlated across countries implied that when one country saw its deficit worsen, so did the others. This was not conducive to peer pressure.

A further weakness in the pre-crisis regime was the absence of a crisis management framework. This was arguably not an accident but intended to support the SGP by demonstrating that there would be no support for countries that broke the rules and found themselves in a fiscal crisis. However, the lack of a framework led governments and market participants to guess that a sovereign default in the euro area and the likelihood that this would trigger a banking crisis would force euro area members to launch a rescue. Paradoxically, the failure to prepare for a sovereign debt crisis in Europe may have made such a crisis more likely.

To improve fiscal discipline, it is important to have a crisis management framework that credibly promises a rescue, but also provides disincentives to governments and lenders. That requires the bailout conditions to be unattractive, both economically and politically, to governments so that they provide firm incentives to avoid a crisis. In particular, assistance must also be subject to strict conditionality and involve stringent reporting requirements. Arguably more importantly, they must be unattractive to creditors so that financial institutions hesitate to lend to governments whose debts are large. For instance, financial assistance should involve automatic debt restructuring that entails a large reduction in the net present value of coupons and the principal.

## 2. THE EFSM AND THE EFSF

As noted above, the Greek turmoil led to the establishment of the EFSM and the EFSF. The former was intended as a stop-gap measure, without a formalized superstructure, in order to avoid an immediate fiscal collapse of Greece. The latter was given a stronger institutional basis – it was established as a special purpose vehicle under Luxembourg law and given staff – but was designed to operate only for a three-year period. The intention appears to have been to demonstrate that the support given to Greece is exceptional and that it has three years to sanitize its public finances. After that, no support would be available for countries that had disregarded the SGP.

However, the temporary nature of the EFSF reduces its effectiveness since it signals that we will soon return to the pre-crisis situation where the SGP, although renegotiated, is again the only institutional arrangement designed to limit the risk of fiscal crisis. Rather than hoping that ambiguity about whether financial support will be available if needed will lead governments to adopt sounder fiscal policies, it seems much better to adopt a permanent framework that specifies under what conditions any help would be made available.

While the adoption of a permanent Crisis Management Framework in response to the Greek crisis might have been seen as undesirable because it would introduce moral hazard by holding out the prospect of financial support to governments borrowing imprudently, the point of such a framework is precisely to deter and prevent governments from accumulating too much debt so as to reduce the likelihood of a public debt crisis. As noted above, that requires the bailout conditions to be unattractive to governments and creditors alike.

## 3. REDUCING THE RISK OF A PUBLIC DEBT CRISIS IN THE EURO AREA

In order to reduce the likelihood of a repetition of the Greek crisis, a framework for the prevention and management of crises is needed. For the framework to be effective, it needs to be designed carefully. Before making some concrete suggestions for the institutional structure of the framework, this section asks what features it should have.

### 3.1 LESS DISCRETION AND MORE AUTOMATICITY

One problem with the SPG was that it relied on governments to take action to invoke the excessive deficits procedure against a peer. For the reasons discussed above, governments would naturally hesitate to do so. While a fully automatic SGP would not be credible since it would suggest that the system was out-of-control and therefore lack legitimacy, it is necessary to introduce a presumption that the excessive deficits procedure will be invoked unless euro area governments collectively take action to set it aside.

### 3.2 IMPROVING FISCAL SURVEILLANCE

The role of short-term political influence in the surveillance of fiscal policy must be reduced. Decisions about whether countries are in compliance with the SGP should be made by a politically independent organ. In order for it to be able to do so, governments must make available more information, and with shorter delay, about their fiscal positions. They should also make available for review the assumptions (regarding growth, debt service costs, one-off items etc.) made when preparing annual budgets.

### 3.3 GRADUATED SANCTIONS

Sanctions need to be graduated and of several forms. Rather than have the excessive deficit procedure come into play discontinuously at a deficit 3%, when, because of its procyclical effects, it cannot be enforced, interventions should start early and become progressively stronger. Initially, they should be primarily of a non-financial form and focus on ensuring whether countries seek to abide with the SGP, not to punish transgressors. This is important for building political consensus behind the revised SGP, which will be crucial for ensuring compliance with it.

### 3.4 GREATER EMPHASIS ON THE LEVEL OF DEBT THAN ON DEFICITS

While the SGP introduced limits on both deficits and debt-to-GDP ratios, the latter provisions were not enforced because too many countries were in violation of them, in some cases egregiously. Since deficits are less important than levels of debt – the main reason deficits are important is that that signal higher future debt levels – this was unfortunate since it shifted the focus away from reducing debt levels.

### 3.5 GREATER FOCUS ON INCENTIVES AND LESS ON RULES

Finally, the SGP should focus less on rules and more on incentives that promote better fiscal policy. A common view before the crisis was that market discipline would provide incentives to limit debts and deficits since investors would hesitate to lend to governments with large debts and demand higher interest rates.

However, this mechanism was inoperative because the interest rate demanded depends not only on the probability that a government will default, but also on the likelihood that it will receive financial support if it does. Unfortunately, investors did not believe that the no-bailout rule of the SGP would be enforced since a default would risk triggering a generalized banking crisis in Europe. In the absence of effective market discipline, a mechanism to raise borrowing costs to provide incentives to limit debt must be found.<sup>3</sup>

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<sup>3</sup> The idea here is that the cost of borrowing is currently too low since it does not capture the “bailout insurance” that membership the euro area entails.

## 4. SUGGESTIONS FOR A NEW FRAMEWORK

In light of the analysis above, what institutions are necessary to guard against a future fiscal crisis in the euro area? How should the SGP be redesigned? And what should follow after the EFSM and the EFSF?

### 4.1 REDESIGNING THE SGP

The SGP needs to be strengthened. Below I sketch a set of reforms that could be contemplated.

First, the SGP will need to come into play at much smaller deficits and at lower levels of debt than is presently the case. Countries experiencing deficits greater than 1.5% of GDP and/or a public debt of 60% of GDP should enter a “surveillance regime.”<sup>4</sup> This regime would require them to provide the European Commission, the ECB and a new European Fiscal Stability Agency (EFSA) with data on budget outcomes, and budget plans for fiscal consolidation. However, there would be no presumption that any immediate policy action needs to follow.

If the budget deficit is greater than 3% or the public debt is greater than 90% of GDP, the country would enter an “enhanced surveillance regime.” This would require governments to present plans to reduce deficits and debt. Moreover, national budgets would need to be presented to the Commission, the ECB and the EFSA for public comment before adoption.

If the budget deficit exceeded 5% of GDP or the public debt is greater than 110% of GDP, the country would enter a “strict surveillance regime.” Under this, the Commission and the EFSA would send resident representatives to follow public finance developments on site and in real time.

To provide incentives to reduce debt, a new Fiscal Stability Charge should be introduced. The annual charge will equal 1% of the stock of public debt above 60% of GDP and will be paid by the national treasury.<sup>5</sup> The charge will be paid to the European Commission, which will return it to the euro area governments on a pro rata basis. Thus, for the euro area governments as a group, the net cost will be zero: the scheme will simply shift the cost of running Europe to the countries that have the largest debt and are most likely to need fiscal assistance.

Given the weak state of public finances currently, the rules would only apply to debt issued after January 1 2011. Since only a fraction of public debt is rolled over annually, it will take some time before the 60% limit is reached.<sup>6</sup>

### 4.2 ESTABLISHMENT OF EUROPEAN FISCAL STABILITY AGENCY

The objective of strengthening the SGP is to reduce the likelihood that a euro area member will suffer a public debt crisis. But the recent experience has demonstrated that euro area governments are too hesitant to enforce the rules for them to be effective. The EFSA will be created as an independent organ to ensure proper surveillance and to trigger the different sanctions of the SGP.

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<sup>4</sup> The proposed thresholds for deficits and debts are only meant as illustrations.

<sup>5</sup> Thus, a country with a stock of public debt equal to 100% GDP would pay 0.4% of GDP per year.

<sup>6</sup> As an illustration, consider a country that has a debt to GDP ratio of 100%, that the debt all has a maturity of 10 years and that the maturity dates are evenly spaced. Thus, this country issues debt equal to 10% of GDP per year. By January 2017 it will have issued new debt equal to 60% of GDP and will that year pay a Fiscal Stability Charge of 0.1% of GDP. Next year, the charge will rise to 0.2% of GDP and so on until it reaches 1% of GDP by 2021.

The main objective of the EFSA is to review annually euro area governments' compliance with the SGP. It will do so by preparing annual reports on fiscal policy developments. Furthermore, it will determine what countries should enter the "surveillance regime" and the "enhanced surveillance regime" of the SGP, and it will be the main organ conducting that surveillance, including appointing resident fiscal policy experts to those countries for which that is required.

For such an institution to be effective, it must be small and not be afraid to take controversial positions. In turn, this requires it to have operational independence from euro area governments and other EU organs.<sup>7</sup> Since determining whether a country is in compliance with the SGP involves judgment and not a mechanical application of rules, it would be appropriate for that decision to be taken by a committee of experts of no more than nine members, rather than a single person, through majority voting. The committee members must be independent (that is, not be civil servants or politically active) and must not be permitted to seek or take advice from the outside. Moreover, they must be recognized experts in the area of banking, fiscal policy or monetary policy. They would be appointed by the euro area governments for a non-renewable term of 8 years. The appointments would be staggered.

#### 4.3 THE EFSF

But even if a revised and strengthened SGP, coupled with stricter surveillance through the new EFSA, will reduce the likelihood of a public debt crisis in Europe, there will always remain some risk of a new crisis. Since the EFSF has been established to deal with a sovereign debt crisis, but is designed to be operational for only three years, it is essential to make this facility permanent. While it would be possible to replace it with a similar institution, the EFSF already exists and already have a detailed set of rules regarding its operations.<sup>8</sup>

Although these rules can be renegotiated and other regimes could be contemplated, at the current stage it seem premature to do so. Instead, attention should focus on redesigning of the SGP and the establishment of the EFSA.<sup>9</sup>

### 5. CONCLUSIONS

To reduce the likelihood and consequences of another fiscal crisis in the euro area, several steps are desirable. The following steps seem crucial and should be taken promptly:

1. The SGP must be reinforced. It should involve more automaticity, have graduated sanctions and focus on providing incentives for better policy.
2. Fiscal surveillance and, in particular, adherence to the SGP must be strengthened by the establishment of the EFSA. This should be small and independent.
3. The EFSF must be transformed into a permanent institution.

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<sup>7</sup> In turn, that requires it to be financially independent.

<sup>8</sup> See the "EFSF Framework Agreement" and the By-Laws of the EFSF, both of June 7 2010.

<sup>9</sup> See also Daniel Gros and Thomas Mayer, "How to deal with sovereign default in Europe: Create the European Monetary Fund now!", CEPS Policy Brief, No. 202, February 2010 (updated May 17 2010).