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The Wrong Euro Reforms Will Deepen the Next Crisis

By Marcello Minenna

It's several months since the last acute eurozone crisis, and recent developments in Athens and Lisbon show that the currency is never too far away from the danger zone. German policy makers in particular are developing proposals intended to stabilize the bloc over the longer term. The risk, however, is that measures introduced now to foster stability could trigger a new and different crisis in the future.

The German plans, first floated in newspapers over the summer and submitted "unofficially" to eurozone finance ministers in September, focus on three points. The eurozone would create a new, independent fiscal watchdog with greater powers and less discretion than the European Commission when it comes to enforcing fiscal deficits of no greater than 3% of gross domestic product. Berlin would introduce a "bail-in" mechanism for creditors in new issues of sovereign bonds. And banks would be subject to new risk weightings in their holdings of sovereign bonds.

These plans sound appealing to some, but problems abound. Consider the proposal for an independent fiscal agency, an idea that has been floating around for some time. The concern is that the European Commission, currently tasked with monitoring eurozone budgets, is too prone to political pressure and too eager to exercise forbearance when a government exceeds the cap.

But the idea of an independent agency would create a new power center, away from political influence and protected from any negotiation process. This would remove wiggle room in a crisis and denotes a mistrust of the regular workings of European institutions. The result would be more centralized but less representative governance.

Far more significant, though, would be the plan for what amounts to a bail-in mechanism for eurozone sovereign bonds. This would bake into bond issues an automatic extension of maturities by at least three years whenever the issuing government formally requests financial aid from the eurozone's bailout fund—introducing the risk of a repayment holiday during the typical three-year life of a bailout program. Moreover, if after a three-year program problems still remained, such bonds could be restructured with little scope for objection from the creditor.

The goal is to prevent the European Stability Mechanism (ESM), the bailout fund, from having to subsidize repayment of precrisis debts during a bailout program. This provision also is supposed to create better incentives to recognize and avoid unsustainable sovereign borrowing. The higher risks associated with bonds issued to big-spending governments under these terms would increase yields, a clear signal to both borrowers and creditors.

The biggest problem here is that this would cement the difference in interest rates for sovereigns within the eurozone. Such divergence, or spread, was long viewed as a problem to be overcome. It tends to erode the competitiveness of affected countries, as higher refinancing costs for governments are quickly transferred via the national banking system to enterprises and consumers. Higher funding costs translate into higher inflation and weaker exports, thus worsening the external imbalances of troubled countries inside the eurozone.

Over time, German policy makers have come to tolerate such differences in rates within the eurozone as inevitable. Now they're embracing them as a desirable outcome. One goal of the bail-in mechanism would be to increase the spread between Germany's interest rate and those of smaller, riskier economies.

'Market discipline' for sovereign borrowing sounds appealing, but limits room for maneuver in a pinch.

Yet by increasing the refinancing costs of smaller, riskier eurozone members, the new rules would make crises more likely, regardless of the level of fiscal rectitude these countries try to achieve. Less risky countries would suffer less, since yields would increase more in the countries with a higher likelihood of requesting support from the ESM. But rates would rise even for fiscally responsible countries because this mechanism would transfer risks from the ESM to bondholders. In practice, this would reduce the benefits of fiscal restraint.

The third German proposal, to adjust the risk-weighting of sovereign bonds on bank balance sheets, would exacerbate this problem. The hope is to bolster financial stability by forcing banks to recognize that some sovereign bonds are riskier than others when assessing their capital buffers. In practice this would amplify the widening spreads as banks, to avoid having to hold more capital against riskier bonds, sell off riskier sovereign bonds, further depressing their prices and raising the yields.

Berlin is responding to the political demands of German taxpayers to be taken off the hook for future bailouts. But policy makers must avoid both creating the conditions for the next crisis, and also creating political tensions when Germany inevitably benefits from widening bond spreads while other eurozone members lose out. Such a "reform" would prove just as destabilizing as the status quo for the common currency.

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