THE EURO AREA CRISIS: A Crucial Opportunity for European Leaders at the G-20

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Framing the Issue

In Europe, the market turmoil that started as a fiscal and banking crisis in a few peripheral countries, has now spread to larger sovereigns, such as Italy and Spain, through increasing spreads in their government bonds vis-à-vis the German Bund and a steady deterioration in the balance sheets of their financial institutions. This has triggered a wave of downgrades that are likely to feed into still higher spreads and a further weakening of financial institutions in Europe.

Policy Considerations

It has become exceedingly clear that the piecemeal approach of European policymakers trying to deal with one distressed country at a time has not worked. Yet, when European finance ministers and central bank governors left Washington in late September after attending the annual meetings of the International Monetary Fund, they left with the commitment to work out a comprehensive approach to resolve what has now turned into a systemic crisis of the euro area. Meanwhile, financial markets have bought into this by exhibiting a "honeymoon behavior" as the previous turbulence has temporarily stabilized. Should European leaders come to Cannes with little in their hands, we are likely to see a further escalation of the crisis with Italy probably being hit the hardest.

The forthcoming G-20 Summit in Cannes is going to test the European resolve to handle their sovereign debt crisis through a systemic response. On the one hand, the financial firepower of the European Financial Stability Facility (EFSF), the European rescue fund, should be increased to make it a credible backstop against the scenario that larger sovereigns may be temporarily cut-off from the market should their borrowing costs further escalate. After more than three months since euro area leaders approved relevant amendments to the EFSF to widen the scope of its interventions, national legislatures in Europe have now finally ratified these amendments. However, these amendments, while helpful in themselves, do not foresee a step up in resources for the EFSF. Therefore, the facility is unlikely to have more bite in tackling Europe's debt woes.

To understand why a beefed-up EFSF is needed to curb further contagion in Europe, one can look at the example of Italy. Currently, the Italian Treasury has to borrow on average some euro 250 billion each year in order to roll-over its public debt. This amount is nearly equivalent to the current residual EFSF financial capacity, netting out for the commitments already taken vis-à-vis the peripheral European economies. In other words, a one-year hypothetical "stand-by" arrangement with Italy would deplete the entire European rescue fund.

The urgency of realigning the EFSF's size also reflects the need to provide a safety net to the weakening euro area financial system. It is plausible that countries already under stress may be unable to recapitalize their financial sectors and consequently the EFSF would serve as the last line of defense. Estimates circulating in the private and official sectors range in the euro 50 to 200 billion. The recapitalization of the euro area financial system has become a high priority for senior policymakers outside of Europe as they recognize the huge potential for global contagion that could come from a distressed European financial sector. This is even more relevant given that Greece looks like it will in fact go through a default—ideally in an orderly manner arranged in cooperation with the private sector.

Action Items for the G-20

Clearly, these are all steps that the Europeans will have to work out at their own European Union Summit that will precede the G-20 gathering by a few days. The G-20 Cannes Summit, however, will provide an opportunity for a collegial assessment of the European response by non-European leaders and for escalating pressure on euro area leaders. Non-euro area G-20 leaders will be able to leverage on the terms of their support for further IMF engagement in the European crisis, including a follow-up aid program for Greece, and a much-needed expansion of the IMF's financial capacity to underpin its financial safety nets.

More specifically, emerging economies—which are expected to contribute to a revamped IMF war chest through bilateral lines of credit—will want to see a sustainable strategy in place before committing their own resources. For the United States, a credible fix in Europe will help to contain a large source of vulnerability of its still fragile economic recovery. However, among U.S. officials and leaders, there is an awareness that they have little ammunition in helping the Europeans solve their debt crisis besides peer pressure and persuasion.

The Cannes Summit will provide yet another opportunity for European heads of state and government to address this ongoing situation. If they squander it, the euro area will most likely be hit by escalating pressures from financial markets through a progressive weakening of larger sovereigns as well as the entire euro area financial sector.