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SOVEREIGN DEBT CRISIS AND ITS IMPACT ON WORLD MARKETS

An IBDE Report

Rudi Guraziu, Epidamn Zeqo

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Crises and Opportunities: The Reshaping of World Markets
The City – London Embassies Series

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Executive Summary

The *Sovereign Debt Crisis and its Impact on World Markets* meeting - as part of The *City-London Embassies Series* on "*Crises and Opportunities: The Reshaping of World Markets*" - aimed to create an opportunity to address the challenges posed by the sovereign debt crisis in some of the countries in the Euro area and discuss possible solutions through a constructive dialogue amongst relevant stakeholders – businesspeople, diplomats, politicians and experts. Drawing on the input from speakers and the discussion during the event, this Report focuses on the developments in the financial and monetary sectors and on public finances, assessing the overall impact on the EU as well as other international markets. While Europe is obviously the region most strongly affected, the pattern of spillover varies, with the strength of trade ties, financial market linkages and Euro area bank exposures all playing a role.

The event's subject was topical, urgent and continues to unfold even as this Report is being written. As was pointed out during the event, it is as if history is being written in real time, or a 'live experiment' being run on the interactions of politics and markets.

This high level, targeted event brought together a wide range of diplomats, policymakers, business leaders, economists and experts from various sectors and institutions. The aim of the event and this Report is to provide a constructive input by effectively addressing the current developments in the Euro area and other countries. A number of key questions were addressed by the panel of experts, diplomats, policymakers and industry practitioners who explored not only the impact of sovereign debt crisis but also discussed the role that high-level inclusive roundtables such as this one may have in shaping the debate on and exploring solutions to such pressing topics for the world markets.

As was noted during the meeting, when faced with an uncertain situation, investors and depositors may overreact. Moreover, the widening of sovereign and bank bond spreads reflected a series of problems: increased deficit, decreased economic activity and diminished tax revenues: lowering growth and fuelling further deficit. This downward spiral can be slowed down with the right policy responses. The key focus should be to restore confidence with leadership: in particular international leadership joined in common purpose. As it was highlighted throughout the meeting, confidence is a means to unlock the funds that are already in the system – however at the moment few lenders have the confidence to provide funding in support of economic recovery and growth.

The content of this Report draws on the discussion topics raised by the speakers and the participants, supported by further research on the subject and the authors' assessments. It focuses on the main discussion topics concerning the causes and impact of the Eurozone crisis, the effectiveness of the mixed policy responses at the member state and EU governance level and the implementation of appropriate strategies to mitigate uncertainty and spur growth in Europe.

The meeting noted that in order to understand the current issues in the Euro area and their impact on international markets one needs to understand:

i) The history of the European Monetary Union (EMU);
ii) The record of the Eurozone in comparison with other currency unions such as the United States (USA);

iii) The integral links between economics and politics in the region;

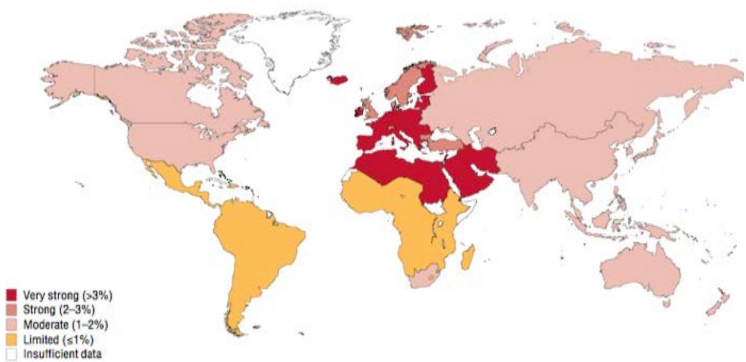
iv) The cycle from banking and fiscal crisis to sovereign crises, particularly in the light of an increasing interconnection among financial markets around the world;

v) The impact of uncertainty on financial markets and the conflicts between long-term solutions and short-term behaviours;

vi) The feasibility of structural reforms while generating growth in the real economy.

Publishing the Report in the midst of the EU debate on the future of the Euro area and European Union is stimulating. The statement of the June 2012 EU Summit is encouraging and will hopefully alleviate the sovereign debt crisis. There seem to be a broad consensus for Euro area's rescue funds, which would directly recapitalise troubled European banks. This is a good step in the right direction and a significant shift in EU Policy.

The Effects of an Intensified Euro Area Crisis on Various Regions
(Peak deviation of output from WEO baseline)



Source: IMF staff estimates 2011

1. Introduction

The Maastricht Treaty (1992) set out the objectives and conditions for the creation of the EMU. The European Central Bank (ECB) was designated as the sole body to pursue monetary policy in the Euro area thus replacing the responsibility of national central banks in member states. National governments were to be responsible for fiscal policy and structural policies. The Euro was successfully introduced in 1999 and came into circulation in January 2002. Consequently, the European economic landscape and cross-border exchanges within the EMU/EU grew tremendously.

The European financial landscape has been transformed in the past twenty years – beginning with the historic passage of the Second Banking Directive and the Single Banking License in 1989. Financial integration increased as cross-border financial flows grew dramatically, and the banking sector consolidated through a wave of cross-border mergers and acquisitions, - all of which allowed Europeans to hold more diversified portfolios. However, EU leaders failed to create a Banking Union that would supervise and be responsible for European banks within the Eurozone.

The introduction of the Euro also led to significant integration in the bond markets, reflecting the belief that monetary union across countries, together with the fiscal rules of the Stability and Growth Pact (SGP), would suffice to guarantee a greater fiscal harmonisation across Europe and thus the solvency of all Euro area countries. Twelve years after the implementation of the EMU, its bond spreads have entered a reverse spiral vis-a-vis their early days.

Fostered by the monetary union and single market, financial and economic integration has brought important benefits, but as with every silver lining there is a cloud: interconnectedness among countries in general and cross-banking in particular, accelerated the transmission of the crisis from its origins and revealed important deficiencies in the regulatory framework. The extent and timing of the impact of the financial crisis in various countries depends on the structural characteristics and policy responses in affected countries. In addition, the crisis has highlighted the need for fiscal consolidation, structural reforms and a new EU-wide growth strategy, which is not financed through additional debt.

The Greek sovereign debt crisis in the Spring of 2010, the subsequent Irish crisis in the Autumn 2010, the application by Portugal and the most recent applications by Spain and Cyprus for European support, all have underlined the problem of sovereign default. For many decades, it was perceived that there was no credit risk for sovereign debt in developed countries. However, over the past twelve years, it has become increasingly clear that the architecture embedded in the Maastricht Treaty was not sufficient to achieve the predefined goals and that there can be credit risk in sovereign debt in Europe.

European policymakers seem to be responding to the crisis with a policy mix of fiscal consolidation, financial integration and boosting of the Euro area's firewall. So far Europe has avoided both protectionism and competitive currency devaluation because of its economic governance. However, the situation is very uncertain and parts of the Euro area have now entered their third and fourth year of recession. Even with mild recession, it has become more difficult to reduce fiscal deficits.

As the meeting noted, the scale of problems we face today in Europe and beyond obliges us to look at new ideas, new markets for exports, the development of new industries, the greater use of technology, with sensible innovation, to make existing businesses more efficient. A good example of sensible innovation is the work that the City of London is currently facilitating with the Chinese and British Governments and City stakeholders to develop London as Europe's centre for the offshore Renminbi. London, a truly European and international financial marketplace, could not only facilitate trade with the world's second largest economy but it is expected to create jobs across the board. Other key emerging market currencies, such as India's Rupee, also represent a growing potential.

Finally, in view of the close interconnectedness of the world economy, an open and constructive dialogue among decision-makers and opinion formers is essential to define policy options and ensure their effective use, so as to lead both the Euro area and the global economy to a sustainable path of recovery. We hope to use The City-London Embassies Series on *'Crisis and Opportunities: The Reshaping of World Markets'* to capitalise on that.

1.1. Structure of the Report

This Report is structured to create a concise review, highlighting the main themes with regard to the causes of the crises, its impact in European and other international financial markets, the current policy responses and the way forward. The background section on the EMU's design flaws and merits seeks to explain the relation between European integration and a crisis which is sometimes seen as a catalyst to deepen European integration and collaboration. Secondly we look at the dynamics of the crisis, identifying the main channels of contagion in international financial markets. Third, we provide an assessment of EU policy-response and that of respective member states. In particular, we stress the need for European policy-makers to pursue simultaneously fiscal consolidation, structural reforms and to focus energetically on growth and job-creation.

2. Background and Origins: A *Sui Generis* Monetary Union Lacking a Fiscal Pillar

The Maastricht Treaty (1992) set out the objectives and conditions for the creation of the EMU, the foundations of which is the theory of the optimal currency area, associated with Robert Mundell and Abba Lerner. The ECB would become the sole body to pursue monetary policy in the Euro area thus replacing the national central banks' responsibility within member states. National governments would be responsible for fiscal policy and structural policies.

The Euro was successfully introduced in 1999 and came into circulation in January 2002. Some of the acknowledged benefits were: i) the elimination of currency fluctuation risks and exchange costs; ii) the lowering of transaction costs and increased competitiveness; iii) the removal of obstacles to business planning; and iv) the establishment of a symbol of European identity and integration.

Ten years from the introduction of the Euro, within the EU and especially within the EMU, there has been a significant increase in cross-border financial and economic activity. The introduction of the Euro eliminated or better mitigated currency risk and provided a further push for financial, trade and services integration. The latter, was particularly a result of harmonisation of market infrastructure, such as the establishment of a uniform cross-border wholesale payment system (Target). Unlike in the USA, cross-border flows within and out of the EU have been dominated by bank flows, reflecting the bank-based nature of finance in Europe. The introduction of the Single Banking License in 1989 through the Second Banking Directive was a decisive step towards a unified European financial legislation and regulation across member countries.

The relative increase in bilateral bank claims involving Euro area members were attributed to three different channels: i) *a borrower effect* by which the creditworthiness of EMU members improves, ii) *a creditor effect* by which the attractiveness of EMU members' banks increases and leads to the growth of inter-bank lending, and iii) *a pair-wise effect* which means joint membership of the Euro increases the quality of intermediation when both lender and borrower are in the monetary union. The effect of the Euro has been even stronger for some peripheral countries of the EMU such as Ireland, Portugal and Greece. The advent of the Euro radically shifted the portfolio of their banks, which traditionally were reliant on dollar debt but subsequently were able to raise funds from counterparts elsewhere in the Euro area.

However, the increased financial integration and reliance on markets, and elimination of currency risk helped plant the seeds for the subsequent crises, together with some country-specific situations. European integration has had positive repercussions for economic development, but has made the region increasingly vulnerable to credit and trade shocks. The increasing interconnectedness of EU/EMU members' banking systems augmented contagion risk significantly – bank failures in one country could wipe out a large share of cross-border liabilities and therefore undermine capital and ultimately banking assets in other countries. This explains why European and world leaders fear a potential Greek and other Euro member defaults as discussed in more details below. It is argued that financial and economic integration does not lead inexorably to such boom and bust cycles and, in fact, can contribute to income convergence.

The following are some other factors that have contributed to the crisis:

- The internationalisation of banking was not adequately matched by regulatory, supervisory, and banking reforms;
- National authorities retained ultimate responsibility, including any public rescues. Therefore, host countries, the banks' cross-border activities notwithstanding, had to rescue each institution independently. Arguably, more fiscal centralisation would facilitate cross-border activity supervision and regulation, which is instrumental for the EMU;
- Markets failed to reflect mounting vulnerabilities in risk premiums until it was too late for a soft landing.

2.1. EMU's Design Flaws

In retrospect, everyone recognises that there are design flaws in the EMU and that it is not an optimal currency area. Fixing its design flaws is difficult since member states are wary of allowing more sovereignty to go to Brussels and Frankfurt by transferring fiscal authority to the supranational European economic governance. In these difficult economic times, members are demonstrating that they are not inclined to make sacrifices for the common European good unless they can clearly identify that doing so is in their own interest. While the pan-European interest is a strong one, it is a very difficult case to make to the national electorate (for national governments it may sometimes be easier to blame Brussels should their domestic policies go wrong). The recent electoral results and government changes in Greece are evidence of this.

That being said, it is important to note that throughout the history of EU integration further integration in Europe correlates with crisis, i.e. European leaders tend to come together especially when confronted with a crisis that requires systemic/treaty changes. In this context, Germany is calling for "more Europe" i.e. more powers to be given to Europe, as a way forward in dealing with the Eurozone crisis.

First, ECB was given a single and narrow objective of price stability without an official role as lender of last resort. ECB's narrow monetary policy for short term CPJ inflation helped to create asset bubbles as it excluded from its purview asset price developments. Additionally, in contrast with the creation of the US dollar, the Euro was introduced without a fiscal union – without federalising state debt, ensuring the central/federal government had the power to tax. With no external exchange rate to depreciate, there was a lack of adjustment constraint, and the 'non-traded' goods sector (i.e. government spending and public sector), and private debt grew when the productive sector's foreign exchange balancer was removed.

Second, EMU's fiscal mechanism did not respond - the SGP was structurally imperfect since it ignored macroeconomic imbalances and the indigenous development and socio-economic models of respective members, in particular in Southern Europe. The SGP was first breached by the strongest members leaving them with no legitimacy to demand that SGP be followed by the weaker member states. The failure of the SGP encouraged debt-financed fiscal expansion during boom years especially in weaker, Southern European members. This resulted in banking losses, public debt problems leading to sovereign debt crisis in Greece, Portugal, Italy, Ireland and Spain.

Third, the crises have revealed that EMU's growth discrepancies and imbalances could not be addressed without a sufficient transfer system. The capital market alone could not solve the transfer system as it was initially thought. Despite the fact that the capital market worked well for a while, private investors started 'convergence trading' with any country entering the EMU and bet that spreads on their government debt would narrow toward the German bonds. These underpriced risks in Southern European countries' sovereign debt markets led to housing bubbles and excess private and public demand for credit. Therefore, instead of capital markets solving the transfer problem, the financial markets exacerbated it. Contrastingly, in the USA, the federal government has had the ability to make transfers across rich and poor states within its federal system, thereby managing to mitigate the risk of the Global Recession turning into a sovereign debt crisis.

Finally, the optimal currency theory, EMU's theoretical underpinning, failed to predict the crisis and to produce a resolution procedure for a sovereign default. Neither was there a clear resolution mechanism for cross-border financial institutions or a cross-border institution operating in several countries. Cooperation among European countries to bail-out a government in distress is voluntary in that there are neither clear rules nor guidelines on how this should be pursued. Some countries are clearly wealthier than others and the cross-border financial institutions operate with important imbalances between assets and liabilities across the different countries.

However, as was rightly mentioned during the meeting, when comparing the EU and the US currencies, it has taken the US over 200 years to have a stable, reserve currency system, during which period the country almost bifurcated over economic issues in the Civil War. It didn't have a central bank until 1913, and the real sense of a unified currency is not nearly as old as the country. Its member states defaulted numerous times on foreign obligations before it achieved anything like stability. In Europe we have had a currency for just over 10 years. This analogy, however, does not mean that EU policymakers should not urgently put the necessary mechanisms in place so as to deal effectively with the ongoing and possible future crises. It is encouraging to observe that recent policy actions agreed during Los Cabos G20 Summit and the EU Summit are rightly addressing some of the systemic problems mentioned in this section, in particular advancing towards a European Banking Union and Political Union.

Credit: UCB

3. The Dynamics of the Financial-Fiscal Crisis and its Impact: The Self-Reinforcing Nature of the Financial Crisis

The Great Recession's impact, especially in Southern European countries, was increased fiscal deficit and government indebtedness. Banks funded much of this increased indebtedness but as the sovereign crisis worsened, concerns about the creditworthiness of the financial sector in respective EMU member states grew considerably. One of the responses by the financial sector was retrenchment in order to improve its resilience, however, by doing so it directly limited its ability to give loans thus negatively affecting growth.

In recent years, up until the clouds of the Great Recession and sovereign debt problem in Southern Europe gathered on the economic horizon, macroeconomists did not pay much attention to banks, whether they were cross-border or domestic banks. Consequently, central bankers and other policymakers missed the build-up of various kinds of systemic risk in the financial system. Systemic risk is defined as 'the probability of default or arrears for the market portfolio of a country's debt due to common or global factors that "systematically" affect all borrower nations. Systemic risk arises from aggregate, and thus correlated, asset risk and from liability risk, as follows:

1) Common exposure to asset price bubbles, particularly real estate bubbles led to problems in the banking systems, e.g., Ireland;

2) Fiscal deficits and sovereign default – possibility of sovereign default of some EU countries created a problem of systemic risk in European banks;
3) Mispricing of assets – this has been a particular problem for those banks holding large amounts of securitised assets that have originated in the US;
4) Currency mismatches in the banking system;
5) Maturity mismatches and liquidity.

The problem that started in Europe in the Spring of 2010 shows clearly that a sovereign debt crisis and the stability of the financial system are closely interlinked. It works both ways: the Euro area crisis puts pressure on the financial system and the financial crisis in Europe puts pressure on the Euro. Furthermore, the EU's financial system and the Euro area share important features, like the lack of resolution procedures and burden-sharing, the reliance on voluntary cooperation among member states and the presence of imbalances.

A sovereign debt crisis puts pressure on bank's balance sheets through different channels. For example, it increases the cost of funding for financial institutions since it increases risk to their assets. Financial institutions holding large proportions of sovereign debt issued by countries in distress, being perceived as being riskier, may have to pay higher interest rates and have more difficulty in raising funds in the wholesale markets. There may also be potential pressure on these financial institutions to raise capital and liquidity holding. Finally, financial institutions operating in the country in distress may also suffer if the country experiences capital outflows and asset substitution and if the large amount of sovereign debt leads to a crowding-out of private investments.

All these types of risks can lead to widespread crises in financial systems through a number of propagation mechanisms, such as panic-based and fundamental runs, and contagion.

Concerns about global spillovers from Euro area and deleveraging, stem from the major role that European banks play in all sectors of global lending. This includes interbank funding, and public sector lending. The risk of stronger financial tensions and effects on economic activity remain, especially if deleveraging by European banks triggers a widespread, sharp increase in risk aversion. Eurogroup's leaders have announced that they have reached a consensus for the creation of an Euro area's rescue fund, which could recapitalise troubled banks directly – after the creation of a strong central supervisor, centred on the European Central Bank. This is a welcomed development that would allow struggling member states more room for adjusting their economies. Yet, more action is needed to further reassure international markets.

3.1. Global Spillovers

Fiscal and financial problems in the Euro are the key possible downside risks to the global recovery, together with: i) commodity prices exceeding those currently predicted by futures markets, ii) overheating in emerging market economies, and iii) possible global spillovers from the Euro area. If the Euro area crisis escalates it is crucial that governments have the appropriate mechanisms and policies to deal with adverse loops between rising funding pressures in the banking system, increased fiscal vulnerability and a slowing in aggregate demand.

In Europe the introduction of the Euro led to a significant integration in the bond market – reflecting the belief that monetary union across countries, together with the fiscal rules of the SGP, would suffice to guarantee a greater fiscal harmonisation across Europe and thus the solvency of all Euro area countries. Due consideration was not given to two factors: firstly, if a country defaults, banks are likely to face severe problems, particularly in the countries where the default occurs, but also in other countries, especially in Europe, given their links through a monetary union; secondly, cross-border institutions operating in a variety of countries and holding a variety of sovereign debt are a potential source of propagation of sovereign default across countries.

Global interconnectedness increases global vulnerabilities: a spike in uncertainty and global risk aversion could lead to deterioration in confidence about the global recovery from the Great Recession. Transmission channels to other regions, in particular emerging Europe, and impact of the spillovers from the Euro area, are dependent on the extent an economy is exposed to Southern Europe's sovereign debt crisis. Key transmission channels are: i) foreign inflows, ii) commodity exports, iii) stronger financial linkages and iv) openness of financial accounts.

Deleveraging in emerging markets is largely channelled through banking flows. Deleveraging by the sale of institutions can be safe if the market for such assets is strong, but if the market is weak, such action may worsen the equity prices of financial institutions in general and make it harder for them to raise capital or funding. While parent bank exposure to subsidiaries within emerging markets held up well during the crisis, there is currently renewed pressure. Also impacted is cross-border lending to corporate or financial sectors and lending through branches. The ability of an emerging market to mitigate the resulting pressures depends on such factors as: i) the market share of domestically-owned banks or banks not subject to deleveraging, ii) development within the local capital market, and iii) the attractiveness of the country as a destination for portfolio investment. A key for emerging markets is to *switch funding sources* - efforts to raise deposits are essential, but policymakers need to ensure that competition for deposits do not undermine the profitability of banks and their ability to raise capital.

Emerging Europe is especially exposed and vulnerable because of two prominent features of the interdependence with Western and Southern Europe: i) banking sector integration – their assets account for more than half of total assets in the banking system in a number of economies and the (ii) build-up of production chains within the context of greater general trade integration, with Eastern Europe being the most dynamic export market for Western Europe. Exposure and vulnerability to the sovereign debt crisis are exceptional issues for emerging Europe, while other emerging regions such as MENA, East Asia and the Americas are experiencing a less severe external shock, and their internal demand and development are driving global recovery. For instance growth in emerging markets has to some extent counteracted the recession and uncertainty in the USA and EU/EMU. They have allowed more time for policymakers to address the crises and have thus contributed to increasing IMF ‘firewall’ for struggling economies, especially for Southern and Eastern Europe. However, European policymakers should avoid complacency and take further steps in mending EMU’s design flaws by increasing the momentum of reform and growth strategy implementation.

The challenge is to manage this process so that it is gradual and does not create instability or harm growth. Pressures on banks to deliver come from regulators and markets, but, at the same time, the demand for credit is constrained by the efforts of corporations and households to reduce their indebtedness. The picture is complicated by the impact of new international regulatory requirements (Basle III) on capital and liquidity. It is crucial that banks are sensibly regulated. Overregulation could harm lending, consequently impacting economic growth.

It is important to point out that the uncertainties as described above contribute to an increased pressure in some countries to look inwards. At its worst this could foster protectionism. As the meeting noted, this needs to be countered and avoided at all cost. History shows that protectionism doesn't work, it simply stifles economic growth and development. Therefore, it is clear that restoring confidence remains the key challenge.

Recent developments in Europe have given some reassurance to international markets that Eurozone's problems are being addressed, and that the crisis can be contained and used to spur new growth opportunities. The Euro area package to save/lend to banks without adding government debts is an important step forward towards improving the sovereign debt crisis.

4. Policy-Response Assessment: Time to Energetically Focus on Growth

To tackle the fiscal and sovereign debt crises, the EU has undertaken a radical overhaul of its economic governance structures (especially in the Euro area) and of its financial sector. It is still too early to tell whether its stabilising policy actions taken across member states have averted a credit crunch, but without further determined action the EU can only expect a subdued recovery. The challenge is to combine fiscal consolidation, stability and growth strategies.

In October 2011 the Commission published "a roadmap to stability and growth" with five interdependent elements. The Commission stresses that, these should be implemented as a package since the measures reinforce each-other. The aim of this package is to break the vicious circle of low growth, reduce the tensions in sovereign debt markets and the vulnerability of the banking sector, and to create a virtuous circle of robust and sustainable economic recovery that will:

1. *Give a decisive response to the Greek problem and avoid a 'GREXIT':* a second EU/IMF programme for Greece has been agreed and a one-off private sector debt write down was successfully negotiated. The situation, however, remains unclear as to whether the new Greek coalition government, produced as a result of 17 June 2012 elections in Greece, will honour in full the agreement with the EU/IMF given the strong opposition in the country.

2. *Enhance the EMU's backstops against the crisis:* first, the 'firewall' has been strengthened by accelerating the setting up of the European Stability Mechanism and by combining the resources of the European Financial Stability Facility with it. In addition, the Commission has launched a consultation on the feasibility of different options for stability bonds, once a sufficient level of fiscal consolidation has been achieved and the sovereign debt risk has been averted. Second, the SGP has been reformed to allow for objectively-based differentiation between EMU member states according to their fiscal space and macroeconomic conditions. Finally, the Commission's fiscal consolidation strategy calls on those member states that have more fiscal space to let their automatic stabilisers to function fully, and on those members under close market scrutiny to tackle their fiscal challenges as part of confidence building measures vis-a-vis the markets. The G20 meeting held in Los Cabos on 18-19 June 2012 has put its weight behind the EU moves to accompany further aid packages for struggling economies with deeper banking union, although this is acknowledged to be a slow process. Medium-term economic sustainability will be built through successive decisive steps in structural reforms and financial stability.

3. *Strengthen the banking system mainly through recapitalisation.* By the time that this Report is being written all the main EU banks should have strengthened their capital bases in a common effort coordinated by the European Banking Authority and in a way that does not lead to excessive deleveraging. The restoration of bank lending to the real economy has also been aided

by the European Central Bank's longer term refinancing operations. The EU is in the lead in implementing G20 commitments to improve the regulation and supervision of the banking sector. In this context, the G20 meeting welcomed Spain's plan to recapitalise its banking system and the Eurogroup's announcement of support for Spain's financial restructuring authority.

4. *Frontload stability and growth enhancing policies.* The growth strategy needs to be pursued with the same determination and speed as the other elements. The Commission has proposed a pro-growth budget for 2013 as well as for the period 2014-2020. However, the UK opposes any budget increase.

5. *Build a more robust and integrated economic governance system.* The new economic governance structures (based on the 'six pack') are up and running, and 25 member states have signed a new treaty on stability, coordination and governance in the economic and monetary union. The Commission is keen to see its proposals for Regulations 14 on further strengthening budgetary surveillance in the Euro area adopted rapidly.

A positive step in addressing imbalances was the Commission's first annual Alert Mechanism Report on 14 February 2012 which marks the beginning of the Macroeconomic Imbalances Procedure (MIP), a surveillance tool devised to detect and correct risky macroeconomic developments in the EU and the Euro area, and thereby strengthen the economic underpinnings of the EMU. The MIP forms part of the 'six-pack' that entered into force on 13 December 2011.

However, as the meeting noted, starting from a basis of delivering fiscal consolidation, the EU needs urgently to deliver in two areas: i) growth enhancing structural reforms, and ii) targeted investment in growth. The recent EU Summit was a good step in this direction but European leaders have to move faster on growth and jobs, which requires *positive* integration – Banking Union and Fiscal Union.

In the area of structural reforms, the Commission seems to be looking at labour market reform, the creation of better conditions for business, and the adaptation of national tax laws to make them more employment friendly. The Commission is currently assessing the national reform programmes presented recently by all member states and is publishing country specific recommendations for all 27 EU member states.

While fiscal stabilisation is essential, faster and deeper cuts are largely self-defeating. A big new push for growth is vital: surplus countries such as Germany are encouraged to promote consumption whilst deficit countries require freer investment. Austerity measures alone cannot solve Europe's economy and financial crisis. However, additional tax measures should not be passed lightly, as virtually all forms of taxation are economically distorting and may thereby harm jobs and growth. An increase in any tax should be contingent on country-specific circumstances. The financial transaction tax remains controversial. The UK argues that the EU-wide introduction of such a tax would harm competitiveness, weaken pension schemes and destroy jobs with possible consequences of banks moving to other parts of the globe such as Asia.

Almost everyone is coming around, not just in Europe, but worldwide, to the recognition that growth is the best way to get out of debt and deficits, and that it is not necessarily incompatible with structural adjustment. The growing debate on austerity versus growth has come even more sharply into focus after the French and Greek elections.

Both the panelists and the participants at the meeting agreed that this "austerity debate" is an overly simplistic and misleading perspective: no-one, including the German Chancellor, is suggesting that growth is not part of the answer. It is a question of how you achieve it without accumulating more debt. There is a need for a much clearer focus on the growth agenda, which is referred to in some circles as the 'Growth Compact'.

A growth package, accompanied by structural reform needs to strike a careful balance between 'transfer-union' and 'austerity'. One policy could be deleveraging and fiscal consolidation accompanied by structural reforms that will ensure sustainability. However, at a time when the private sector is trying to reduce its debt, any attempt by governments in most countries to do the same through budgetary contraction risk sending European economies down a deflationary spiral. Therefore, countries with a margin of manoeuvre are advised to boost domestic demand, while for those less fortunate, fiscal consolidation should not be excessively frontloaded.

5. Conclusion

If this crisis has taught us nothing else over the past few years it is that we are all interconnected as part of an increasingly global economy, both within Europe and more globally. Despite the understandable and inevitable pressures to look at this crisis as an internal European problem there is a need to look at the Sovereign Debt Crisis in a global context.

The main tenet in this Report was that, the problem that started in Europe in the Spring of 2010 shows that the sovereign debt crisis and the stability of the financial system are closely interlinked. The relationship works both ways: the Euro area crisis puts pressure on the financial system and the financial crisis in Europe puts pressure on the Euro.

Although financial services have been part of the problem over the past few years, they are also a part of the solution. Financial services support directly and indirectly the wider economy. This is especially true when one considers the role of The City, a truly European and global financial centre. The interconnectedness of the financial sectors within Europe and internationally has reduced barriers to capital flows. The increasing integration of the European banking industry offers the prospect of important gains in terms of efficiency and diversification, though it also bears potential risks. One such risk is the cross-border contagion risk of the effects of a shock to the capital of a bank that is active internationally.

Understanding the role of banks in cross-border finance has become an urgent priority after the recent crisis where they played a central role. EU legislation for the EMU was not written with the existence of large, systematically important subsidiaries or branches in mind. This report argues that there have been regulatory and systemic shortcomings to deal with large-cross border banks in an efficient way, that have contributed to a deepening crisis. In addition, the report notes that macro-prudential, monetary and fiscal policies have to be adjusted to take into account the repercussions of cross-border banking for asset price and credit booms, currency and maturity mismatches and contagion.

Sensible macroeconomic policy-making is no longer possible without taking into account the feedback loop within the financial system and EMU's design flaws. Therefore, banking supervision, regulation and resolution need to be elevated to the level at which banks operate in a financially integrated region.

As this report argues, EMU's design flaws are determinant factors. Some argue that a uniform monetary policy for a heterogeneous group of countries lies at the heart of Euro area's current problems: uniform interest rate policy for a heterogeneous monetary union reinforces the differences between countries instead of leading to their convergence, therefore, representing a mechanism for crisis. However, this does not imply that the monetary union is bound to fail, nor that the heterogeneity of real interest rates is unequivocally a cost of monetary integration. It needs to be said that, the theoretical concept of an *optimal currency area* has made us forget that diversity is the basis for trade, credit and mobility, as well as policy coordination. If the EMU is considered as an insurance policy, than such differences provide an opportunity for risk diversification and thus the possibility of reducing the risk for everyone in the insurance pool. Already we are observing debt sharing mechanism, which some see as a step towards establishing shared Eurobonds: Eurobonds with a uniform interest rate could address the low growth risks and debt servicing of struggling member states. That said, Eurobonds carry moral hazard and should not be seen as the solution to the crisis, and should be considered to be introduced only after the implementation of structural reforms and fiscal consolidation especially in the southern indebted European countries.

Appropriate fiscal consolidation/reforms can restore confidence of the financial markets since they have both short-term and long-term effects – for example, the UK has regained credibility and borrows at historically low rates, while the borrowing costs for Spain and Italy are exceptionally high. Therefore, the adoption of the Fiscal Compact and its ongoing implementation, together with growth-enhancing policies and structural reform and financial stability measures, are crucial steps that lead to sustainable borrowing costs. However, to get the EU growing at a sufficient rate to create jobs, fund much needed investment and support Europe's social support systems, a mix of ingredients is needed. Some have already been implemented at an EU level.

The EU Single Market still has untapped potential to deliver new sources of growth and jobs. As this report argues it is clear that the priority has to be growth, and this can only come through jobs, which can come through continuing support for the Single Market, the main reason why Europe attracts investment. Much can be done at EU and national level through growth enhancing structural reforms, such as:

- Early implementation of the Late Payments Directive: the Commission estimates that, if all Member States fully implemented the Services Directive estimates the EU would gain up to 1.8% in additional growth;

- Going digital: Commission’s estimates show that EU GDP could grow by 4% by 2020 if the EU takes the necessary steps to create a modern digital single market;

- Boosting innovation: the introduction of the long awaited EU patent. An example of sensible innovation was cited in this report;

- Unleashing the potential of "green" growth;

- Strengthening employment policies: the Commission's recent employment package, if implemented, it may arguably create up to 20 million new jobs;

- Drawing on external sources of growth: by accelerating trade and investment negotiations with dynamic third country partners;

- Targeting the EU structural funds more on competitiveness and convergence;

- Targeted investment in 21st century infrastructure;

- Increasing the lending capacity of the EIB: as proposed by the Commission in 2011, a paid in capital increase (of at least € 10 bn.) would help the EIB to expand its lending capacity where it is most needed, especially towards SMEs. The EU could also expand the risk sharing instruments with the Bank in a range of areas.

We welcome the important developments from the recent G20 and EU Summits: namely for a new 750 billion Euro bond-buying mechanism and direct bank recapitalisation without burdening government debts. The June 28-29 EU Summit showed that solidarity remains a real characteristic of the European project. The convergences of national interests at this time of crisis increase hopes that European leaders will also deliver on growth and jobs.

In conclusion, the EU needs to show the same speed and determination in implementing its growth agenda as it has shown in fiscal consolidation. While the return to lasting growth will take time, a turn around can be achieved by the end of this year if the necessary decisions are taken now.

Photos from the meeting on Sovereign Debt Crisis and its Impact on World Markets, German Embassy, London 11 May 2012.

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