

## Chapter 16 – Government Funding: Crisis Challenge in the Euro Area

The founders of the European Monetary Union (EMU) created rules to make sure that member countries would keep their fiscal houses in order. In that way, no government would be tempted to pressure the European Central Bank (ECB) to create inflation (see Chapter 15). One rule – the so-called *no-bailout* requirement – forbids the ECB from directly helping an individual government that faces borrowing difficulty. The ECB’s designers wished to ensure that it could never be forced to sacrifice price stability to finance a fiscal deficit.

These issues gained importance in the financial crisis of 2007-09. For the first time since EMU began in 1999, investor doubts about the fiscal health of some countries led to a large widening yield spreads for the government debt of Greece, Ireland, Portugal, Italy, Spain, and Belgium, relative to the yield on German debt – which serves as the euro-area benchmark and enjoys one of the lowest yields in the region.<sup>1</sup> The spreads during the crisis set EMU-era records.<sup>2</sup>

And policymakers feared that the crisis could become even more disruptive.<sup>3</sup> In the extreme, the funding liquidity of a government can evaporate, just as it did for many banks, households and businesses during the crisis. The history of sovereign borrowing is replete with examples of such disruptions, sometimes called *sudden stops*. For instance, the crises that plagued emerging economies in recent decades often led to a loss of government funding liquidity.

Governments that have borrowing difficulties in a recession may face a vicious cycle. Tightening their belts to reduce borrowing can depress their economies and widen, rather than narrow, their budget deficits. Increased borrowing needs then intensify doubts about their fiscal health. In the Great Depression, for example, tax hikes and spending cuts backfired: Such *pro-cyclical* fiscal actions diminished economic activity so much that revenues plunged and budget deficits widened. When possible, governments aim at *counter-cyclical* policies that promote economic stability (core principle 5), but they may have little fiscal flexibility in a crisis.

Importantly, the fallout in the euro area would not have been limited to those countries facing a sudden stop. The economies of euro-area members are closely linked. Most of their international trade occurs with other euro-area members.

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<sup>1</sup> A government bond yield spread usually is a market indicator of sovereign default risk (see Chapter 12), but crisis spreads also reflected differences in market liquidity.

<sup>2</sup> For example, early-2009 spreads on 10-year Greek and Irish government bonds temporarily surpassed 250 basis points (a basis point equals 0.01%). Prior to the crisis, these spreads were about 25 basis points and zero basis points, respectively.

<sup>3</sup> In February 2009, for example, one member of the ECB Governing Board told the European Parliament in February 2009 that “there is a risk that mistrust that there is today in the financial markets ... is transformed into a mistrust in the state.” See: <http://in.reuters.com/article/governmentFilingsNews/idINLB69456820090212?pageNumber=1&virtualBrandChannel=0>

Many companies operate in a range of euro-area countries. As a result, lack of government funding that would depress activity in a group of countries would quickly spill over to their neighbors through declining trade and profit. This common fate probably encourages greater solidarity among policymakers.

Yet, how could the euro area address these potential instabilities as yield spreads widened? The ultimate threat was a disruption of governments' ability to borrow – sovereign funding liquidity. Yet, the no-bailout rule limited the possible response of the ECB – the euro area's lender of last resort (LOLR). Any systematic effort to favor the debt of one government over another – to narrow yield spreads or to counter a sudden stop – could be seen as a violation of the rule.

Faced with the deepest recession in the postwar period, euro-area fiscal leaders had every reason to prevent a wave of government funding crises. What could they do to reduce this risk? The extraordinary circumstances called for some policy innovation. One approach would be to make EMU member countries the joint LOLR for a distressed government. During the crisis, there was no time for such a complex and elaborate innovation to emerge. Instead, hints of possible fiscal burden-sharing among EMU members helped to calm the market storm.

In February 2009, Germany's Finance Minister stated publicly for the first time that some governments are "getting into difficulties" and that "the other states would have to rescue those running into difficulties."<sup>4</sup> The statement effectively acknowledged that the euro area could not afford a sudden stop, and indicated that EMU members would cooperate to prevent it.

Current and future bondholders viewed the statement as important for several reasons: (1) Germany is the largest euro-area economy; (2) Its size and fiscal health mean that it could credibly aid other euro-area members in distress; and (3) Germany had been the leading advocate of the ECB's no-bailout rule and other EMU provisions aimed at fiscal prudence. While it did not apply to the ECB, the Minister's statement was seen as an about-face on the principled resistance to bailouts for euro-area governments. Perhaps as a result, euro-area government bond yield spreads stopped widening.

When historians look back at this episode, they may conclude that hints of fiscal cooperation played an important role in euro-area crisis management. However, it remains to be seen how far European governments will go to cooperate in practice. If a euro-area government faces a sudden stop in a future crisis, will other EMU members grant a loan?<sup>5</sup> That would be a new LOLR.

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<sup>4</sup> See, for example: <http://www.bloomberg.com/apps/news?pid=20601085&sid=aAog4Vqb6SGQ>

<sup>5</sup> Such a loan would be comparable to the official loans granted to emerging economies facing sudden stops. Official international lenders to emerging borrowers (such as the International Monetary Fund) often impose strict conditions on the governments receiving such emergency finance.