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Terms of Crisis

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Abstract :

The multifaceted nature of the economic and financial crisis that has been affecting the euro zone for the last three years and the multiple institutional responses that the European Union has attempted to provide has led to a specific lexical field. This glossary tries to define in simple terms the concepts of economic theory, the key ideas from a budgetary point of view, the terms borrowed from the financial markets, the issues at stake for each State that is receiving financial aid and the measures implemented nationally or on a European level. The aim is to provide every "crisis word" with a definite, clear meaning so that the latter can be understood better. It targets as wide an audience as possible.

- MORAL HAZARD

The philosopher Adam Smith defined moral hazard in the 17th century as "*the maximisation of individual interest without taking account of the unfavourable consequences of the decision affecting collective effectiveness.*"

In the insurance sector the concept of moral hazard means the ability on the part of the insured to take greater risks as long as he does not have to assume any of the negative consequences of his acts due to nature of the insurance policy he has subscribed to.

When applied to the economic and financial crisis, which the euro zone is now suffering, this concept underscores the financial risks taken by certain banks which are guaranteed State intervention in the location they are established if there is a danger of bankruptcy.

- SELF-FULFILLING PROPHECIES

According to British economist John Maynard Keynes, in the face of a slowing in activity economic actors anticipate the future pessimistically by freezing their investments or their consumption. In the end behaviour like this leads to an even greater contraction in activity.

The same logic can be applied to the sovereign debt crisis experienced by the euro zone. In the face of rising interest rates on sovereign bonds and a State's inability to honour its commitments long term, investors or the credit ratings agencies deem that other countries which show similar difficulties – or at least in part – will find themselves in the same situation. The purchase of bonds from these States is then deemed risky, which adds to rising interest rates and therefore an increase in borrowing costs. The countries concerned find it impossible to refinance on the markets.

- REAL ESTATE BUBBLE

An economic or speculative bubble is typified by a significant gap between the exchange price of a good and its intrinsic value. In terms of a real-estate bubble the difference in values is enabled by a macro-economic context that favours investment in this sector (low stock yields and high quantities of available liquidities) and low interest rates. This favours both debt and purchases at prices beyond the market's real value. Buyers and investors also anticipate a constant rise in prices. The bubble collapses or bursts when supply is lower than demand or if buyers perceive they cannot reimburse their loans, with the danger of crippling the balance sheets of the financial establishments which have lent to them. The price of the goods in question may then collapse. The bursting of the real-estate bubble has been one of the decisive elements in the Cypriot, Spanish and Irish crises.

- CONTAGION

Contagion supposes that the economic and financial crisis in a State could spread to another State. Several factors promote contagion: the political and economic links between the two countries or a similarity in their financial situations. An extremely indebted country will also find itself in the same position – either in the short or mid-term. The mistrust of the markets then leads to an increase in interest rates on borrowing and causes a financial predicament.

In spite of the specific nature of each economic and financial situation in each Member State the euro crisis is marked by contagion. The aid granted to Greece 2010 did not prevent a hardening in access conditions to the financial markets for Ireland, Portugal, Spain and Italy. These refinancing difficulties even led Dublin and Lisbon to turn to the European Union for help.

- COMPETITIVENESS AND GROWTH CONTRACTS

As part of the vital improvements in the coordination of EU economic policies, the European Council of 13th and 14th December 2012 opted for the principle of "competitiveness and growth contracts" that the EU's Member States might conclude with the European institutions in view of strengthening their competitiveness. The EU might then subsidise the implementation of structural reforms in the Member States. A fund of between 10 and 20 billion euros would then be devoted to financing these contracts.

The presidents of the European Council and the European Commission have been asked to present a roadmap in June 2013 detailing the modalities of these contracts and their financing.

- *CREDIT DEFAULT SWAP* (CDS)

Credit default swaps (CDS) are a form of insurance against the risk of payment default on a loan issued by a State or a business. Unlike a traditional insurance contract it is a financial instrument classed as a derivative and is negotiated directly. Hence it is possible to acquire a CDS without necessarily own the matching debt bond. The first CDS was set up in 1995 by the American bank *JP. Morgan*. The rating of CDS's enables a default risk assessment of a State or a business.

The triggering of CDS's, i.e. the payment of a bonus, may occur if the business or the State defaults, when it declares a moratorium on its debt or when it restructures its debt, on condition that the restructuring legally binds all of the bond owners. It is the responsibility of the *International swaps and derivatives association* – ISDA to decide whether the bond issuer is in a position of default.

Since November 2012 the European Union has banned the purchase of naked sovereign CDS, i.e. for purely speculative ends. It is now prohibited for investors to acquire CDS's on sovereign debt instruments if they do not own the matching bonds.

CRISIS

- CYPRIOT CRISIS

The Cypriot crisis is due to the coincidence of several factors that are specific to its own economic mode, since the island's partition in 1974 local economic growth has indeed been driven by two activities: financial services and tourism. An advantageous tax system, favourable remuneration rates and a tradition in consultancy that dates back to the British colonial times have all attracted a number of offshore funds and also Russian capital that fosters the development of local banks and yet is unrelated to the country's real economic potential. The oversizing of its banking sector means that there has been massive investment in the tourist real estate sector – with the danger of a bubble emerging and also a dangerous investment strategy with its Greek neighbour. In addition to the lack of prudence on the part of the Cypriot banks the local economy is not very competitive and spending has been a heavy burden.

The depreciation in value of the Greek debt bonds held by private creditors led to losses on the part of the Cypriot banks totalling 25% of the GDP in February 2012. This led the authorities to invest en masse in the financial sector to recapitalise. This happened even though the economy was suffering the effects of the collapse of the real estate bubble.

Since Cyprus found it impossible to refinance on the markets, the EU and the IMF announced a bail-out of 10 billion € on 25th March 2013. In addition to this we might add the contribution made by private depositors as part of a vast restructuring operation of the banking sector: depositors with over 100,000€ in the country's two most important banks were obliged to pay a levy of over 30%.

- SPANISH CRISIS

The advantages associated with EU membership, then of the euro zone, helped Spain modernise its infrastructures significantly and raise its economy to become the 5th most important in Europe. Debt helped stimulate growth in all sectors but no reform was undertaken to consolidate its competitiveness and strengthen its position as a "model" in the European club. Low interest rates did however lead to an exponential increase in investments in the building sector without there being any link being formed with real demand in terms of housing. The purchase of housing was seen as an extremely profitable investment, via long term mortgages (35 to 50 years) at variable rates. The world financial crisis came and, as in Ireland, it invalidated this strategy opening the way to a solvency crisis in the local banking sector which is notably typified by a significant network of regional savings banks. Massive investment by the Spanish State in recapitalising the banks weakened its financial situation that had already been weakened by an major economic crisis which brought to light a lack of competitiveness. The EU and the IMF granted a bail-out of 100 billion € to Spain in June 2012. This loan was only designed for the restructuring of the local banking sector. The issue of a second package to be used to respond to debt refinancing difficulties encountered by the Spanish authorities is still an issue.

- GREEK CRISIS

The world economic and financial crisis highlighted the lack of competitiveness of the Greek economy, the authorities' inability to undertake structural reforms and their addiction to public spending. Low interest rates caused by the entry into the euro zone made it easy to refinance local debt that totals over 100% of the GDP. The downturn in the world economy led to greater public deficit and caused increasing mistrust on the part of the financial markets. The country then showed signs that it was suffering a solvency crisis.

The EU and the IMF then made a 110 billion € bail-out in 2010, the first of its kind. This loan was conditioned by the introduction of structural reform designed to guarantee the sustainability of the public debt. The fear of contagion led the EU to create a special facility: the European Financial Stability Facility (EFSF).

The continued downturn in the economic situation and the problems encountered by the authorities in completing the programme, which combined modernisation and austerity, did not help relieve the financial stranglehold. A second aid plan was therefore decided upon in February 2012 associating further international financial aid (130 billion €) and the participation of private creditors (discounting or re-scheduling of the securities they owned). The maturity of international loans was extended in October 2012, simultaneously a programme to re-purchase discounted securities was established. In spite of these measures the Greek public debt still represents nearly 190% of the local GDP.

- IRISH CRISIS

The Irish crisis was mainly due to the collapse of the local real estate bubble. Real estate fever was caused by many factors. A euro zone member, Ireland enjoyed low interest rates, which were below inflation. Access to property ownership was, in addition to this, an ideal for the population which had just found relief after decades of poverty. With the downturn in the economy the local banking establishments, which had invested massively in this sector, encountered major difficulties, with the State being forced to recapitalise and nationalise them. Simultaneously this led to a risk of overburdening its public debt. Ireland then faced a liquidities crisis in a morose economic context.

In November 2010 Dublin received a bail-out from the IMF, Sweden and the UK of 85 billion €. Since then the country has recovered growth, which has mainly been driven along by exports. Ireland's respect of its adjustment programme should lead to a full return to the financial markets by the end of 2013.

- PORTUGUESE CRISIS

The difficulties encountered by Portugal to refinance its debt were due to the intrinsic weakness of its economic model, which the adoption of the euro only made worse. Since the adoption of the single currency average GDP growth in Portugal has been below zero. Unlike the Irish crisis and even that in Spain, which were due to quite specific banking issues and therefore in part because of the economy, the Portuguese crisis is of a structural nature. It notably raises the issue of the reconversion of its economic model. Indeed Por-

tugal has been experiencing weak growth for the last ten years.
Integration into the euro zone was also significant. Encouraged to overvalue the escudo as it transferred over to the euro, Portugal faced a competiveness/price problem. The textile industry suffered in particular. The adoption of the single currency demanded a real conversion of the Portuguese economy. The entailed a competitive leap based on quality and not just on price policy. Nominal convergence – ie the convergence of inflation indicators, interest rates and the flux in exchange rates of the countries which wanted to join the euro – which came with the adoption of the single currency, was not followed by real convergence as those who advocated the euro had intended. Worse still, nominal convergence enabled the country to enjoy low interest rates. Since no difficulties were encountered on the debt market this led to the idea of easy access to money, postponing any intention to adjust the Portuguese economic policy to the reality of the markets.
Since May 2011 Portugal has been benefiting from financial aid on the part of the EU and the IMF to a total of 78 billion €.

- LIQUIDITY CRISIS

Although it might be able to repay its debts, a liquidity crisis means that a State can incur no more debt since investors refuse to lend it any more. It is different from a solvency crisis in that the State is unable to reimburse its debts.
A liquidity crisis normally leads to a loan by an international institution to a State otherwise a solvency crisis might ensue, since the State has to sell its assets at low prices to service the debt. The Irish crisis was typical of a liquidity crisis. Italy's problems may also lead to this type of crisis. However in the case of a solvency crisis it does not appear useful to lend more to a State which finds itself unable to reimburse its debts. It is then necessary to restructure the public debt and introduce policies which aim to restore solvency. The Greek crisis is one of solvency.

- SOVEREIGN DEFAULT

In the case of sovereign default a State is unable to pay off all of its debt. Sovereign default implies that a State cannot return to the financial markets to refinance itself. A defaulting State, like Argentina in 2001, has to balance its budget and constantly have a surplus trade balance since it cannot borrow to finance its deficits or imports. The threat of sovereign default on the part of Greece led the EU to implement a restructuring of the public debt in 2012, leading to losses on the part of its creditors.

DEFICIT & DEBT

- EXTERNAL DEFICIT

The external deficit is when a State's trade balance is in the negative. This is the difference between the monetary value of a country's goods and services exports and the monetary value of its goods and services imports. A negative trade balance or an external deficit means that a country is importing more than it exports.

- PRIMARY DEFICIT

The primary balance reflects a State's budgetary situation before the debt service payment. A State can have a primary surplus and yet be in budgetary deficit because of its debt. This is the case in Italy. The primary deficit is equivalent to a negative primary balance. The primary balance defines the real budgetary situation of a State at a precise moment in time, without taking into account the consequences of financing the deficits of previous financial years via borrowing.

- PUBLIC DEFICIT

The public deficit is the annual negative balance between a State's revenues and spending by local communities and social security organisations. According to the Stability and Growth Pact (SGP), adopted in 1997 the public deficit of each of the EU's Member States cannot rise beyond 3% of their GDP.

- PUBLIC DEBT

The public debt is the total of all loans contracted by a State, its local communities and social security organisations. According to the Stability and Growth Pact (SGP) adopted in 1997 the public debt of each of the EU's Member States cannot rise above 60% of their GDP.

- EUROBILLS

The eurobills project is one of the proposals put forward in October 2012 by the President of the European Council, Herman van Rompuy in view of strengthening Economic and Monetary Union.

The euro zone would be able to borrow and then issue short term sovereign debt securities: *eurobills*, would be designed to satisfy the short term refinancing requirements of euro zone Member States. The latter would provide a joint and several guarantee for these securities. The issue of these would be conditioned by the respect of the States involved of the budgetary supervision rules included in the *two-pack*.

The volume of eurobills issued for each State would not exceed 10% of their GDP. For long –term financing requirements States would continue to raise funds autonomously on the markets.

For the time being this project has not been followed up since the European Council is not unanimous about it.

- EURO-BONDS

The term eurobonds (*eurobonds*) refers to a project to issue joint debt securities by euro zone Member States. These securities would then substitute the bond issues by each State and would thereby enable a pooling of the euro zone debt. Pooling would lead to a reduction in interest rates for States encountering economic and financial difficulties. The project is encountering a certain amount of reticence however: an increase in interest rates for certain States and the danger of moral hazard. The Member States which enjoy a reduction in interest rates would no longer be inclined to undertake the structural reforms expected of them. It also supposes that the euro zone would have real budgetary capacity enabling it to borrow.

- EUROGROUP

The Eurogroup is an informal meeting of Finance Ministers of the Member States of the Economic and Monetary Union (17 to date), which the President of the European Central Bank and the Vice-President of the European Commission responsible for economic and monetary affairs have joined. The Eurogroup meetings are held once a month on the eve of the Council of EU Economy and Finance Ministers (Ecofin). They address issues relative to the economic development of the euro zone, the States' budgets, who are members and exchange rates.

An ad hoc body, its role was acknowledged in protocol No.14 that was annexed to the Lisbon Treaty without any challenged being made however its informal nature. Until January 1st 2005 it was led by the Finance Minister of the country ensuring the presidency of the European Union. The Eurogroup president has since then been elected within a college of ministers for a two and a half year term in office.

- EUROPEAN FINANCIAL STABILITY FACILITY

Launched on 9th May 2010 on the occasion of the exceptional summit of heads of State and government of the euro zone in Brussels, the European Financial Stability Facility (EFSF) is a joint fund of non-permanent debt instruments designed to provide financial assistance to euro zone Member States which are facing default. The granting of funds is strongly conditioned. The end of the EFSF's mandate has been set for 30th June 2013. Since the EFSF has no capital it finances itself on the markets. It can take out loans with the guarantee of the 17 euro zone Member States. It is activated by the unanimous decision of all of the participating States. Initially it was provided with 440 billion € in guarantees, a total that was brought up to 500 billion in March 2011. Its mission has gradually been extended. In addition to the granting of financial aid to a State in difficulty it can now open a preventive credit line, repurchase bonds on the secondary market and it has the right to take part in the recapitalisation of banking establishments thanks to loans made to governments.

The EFSF was used in Ireland in December 2010, Portugal in May 2011 and as part of the second bail-out to Greece in February 2012.

The European Stability Mechanism (ESM) is a permanent fund that is provided with capital and was launched in October 2012 and will finally take over from the EFSF at the end of its mandate – taking over most of its tasks.

- FONDO DE REESTRUCTURACIÓN ORDENADA BANCARIA (FROB)

The *Fondo de Reestructuración Ordenada Bancaria* (FROB) or the Bank Restructuring Fund was created by the Spanish government in June 2009 to help financial establishments overcome the effects of the collapse of the real estate bubble. In the event of difficulties banks and savings banks could ask for public aid by the FROB. If the FROB invests in a savings bank the latter has three months to become a bank. FROB intervention in banks is conditioned by the adoption of a re-structuring plan designed to reduce costs.
European aid of 100 billion € targeting the banking sector was paid directly to the FROB in June 2012.

- REDEMPTION FUND

The Redemption Fund is one of the proposals made European Council President Herman van Rompuy in view of strengthening Economic and Monetary Union presented in October 2012.
This fund would be used to manage the surplus public debt of euro zone Member States, i.e. when this rises above 60% of the GDP, i.e. 2,300 billion €.
The guarantee provided by the States with triple A's in the euro zone (Germany, Finland Luxembourg and the Netherlands) would enable the fund to borrow on the financial markets at rates that are clearly below those paid at present by countries in difficulty. The rate might be close to 3%. Only the States that respect the criteria of the treaty on Stability, Coordination and Governance will be able to access this fund. They would contribute financially by reimbursing the interest but also by paying some of the transferred debt. The debt managed by the Fund might also be cancelled after a period of 20 to 25 years.
The European Council of December 2012 did not follow up on this project. As part of the negotiations with European Parliament on the adoption of the two-pack the Commission announced the creation of a group of experts responsible for assessing the feasibility of the redemption fund. This group will have to deliver its conclusions by March 2014.

- DEPOSIT GUARANTEE

Adopted in 1994, the directive on the deposit guarantee scheme makes it obligatory for all Member States' financial establishments to join a national deposit guarantee fund, designed to compensate depositors in the event of bankruptcy. The original text planned for a reimbursement of all savings of each depositor to a limit of 20,000€. In 2008 the economic and financial crisis of 2008 led the EU to raise this ceiling to 50,000€ in 2009 then to 100,000€ as of January 1st 2011.
With the Cypriot crisis the EU and local authorities implemented a levy on deposits whose value was over 100,000€ to enable the restructuring of the country's two main banks.

- HAIRCUT

A *haircut* comprises a reduction in the value of the assets held by a lender/creditor as part of the restructuring of a State's or a company's debt.
This technique was used as part of the second bailout to Greece decided in February 2012. 53.5% of the value of the debt held was cancelled, i.e. savings of 107 billion €.

- INITIATIVE FOR YOUTH EMPLOYMENT

Given the rise in unemployment rates amongst the under 25's everywhere in the EU (13 million people), the European Council decided on 15th March 2013 to introduce a specific policy: the Initiative for Youth Employment. It targets young unemployed people who are neither studying nor training in areas of the EU that had youth unemployment rates over 25% in 2012. Six billion € for the period covering 2014-2020 were granted to this programme. This sum will enable support to the proposals included in the "youth employment" package presented by the Commission in December 2012, notably that concerning the introduction of a youth guarantee in every Member State by 2014. According to this package all young people under

25 should be made a quality offer as far as employment is concerned, additional training; apprenticeship or a training period in the four months following the end of their formal schooling or the loss of their job.

- PRIMARY/SECONDARY MARKET (OF A SECURITY)

The securities market is divided into two categories: the primary market where newly issued bonds are purchased and the secondary market where purchasers of debt securities can sell the bonds they have purchased to other investors.

The sale of securities on the primary market occurs in three different ways:

• a syndicated transaction, resembling a bank loan, comprises the sale of securities to financial establishments that work together on this occasion;

• the pre-purchased transaction without any real negotiation;

• sale by auction.

The secondary market is used as an indicator to assess interest rates on a State's securities and notably to establish the *spread*.

- EUROPEAN STABILITY MECHANISM

Launched in October 2012 the European Stability Mechanism (ESM) will take over from the European Financial Stability Facility (EFSF) the mandate of which is due to end on 30th June 2013.

The ESM has a set capital of 80 billion €. To this sum we might add the 200 billion € that have still not been used by the EFSF. The contribution of the 17 euro zone Member States into the ESM's capital depends on their economic weighting. Germany (27%), France (20%), Italy (1%), represent 65% of its capital.

The ESM has four means of action:

• The granting of conditioned loans to States which request them;

• The purchase of debt securities from a Member State on the primary and secondary markets. An ECB analysis must previously justify this type of intervention. The State in question must sign a memorandum of understanding prior to this with the ESM which sets out structural reform;

• Preventive financial assistance in the shape of a credit line based on the opinion of the European Central Bank. The State in question has to adopt budgetary adjustment measures negotiated with the Commission and the ECB;

• Recapitalisation of banking establishments by way of loans granted to the governments of the countries where they are established. The entry into force of Banking Union might mean that the ESM pays the necessary sums to the establishments directly which could help prevent a worsening in States' debts.

- MEMORANDUM OF UNDERSTANDING (MOU)

Memorandum of Understanding (MoU) formalises the agreement between the EU, the ECB and the IMF on the one hand and the Member State which has requested financial aid from the ESM on the other. Negotiated by the European Commission, it specifies the reforms to implement by the authorities of the country requesting aid if they want to receive the loan. This is paid in tranches according to the completion of the MoU.

-SOVEREIGN DEBT RATING

The ratings agencies are responsible for independently assessing the risk of default on reimbursement or bankruptcy of an actor issuing debt bonds. They inform investors of the danger being run if they lend to a State or a business. They rate the securities on the issuers' request which remunerate them accordingly. Three agencies share the ratings market: *Fitch*, *Moody's* and *Standard & Poor's*.

The rating of sovereign debts can be made without the specific request of the State in question. It is not based on a mathematic or econometric model which would automatically define a rating according to economic performance or the level of debt. Analysts working for the ratings agencies give preference rather to various economic and financial indicators: GDP per capita, inflation, exports the existence of sovereign default over the previous 25 years, and economic development indicators etc. The political and institutional features of the countries being rated are also taken into account.

The ratings grid is subdivided into two categories: in the first instance the security is considered as an investment (ratings ranging from AAA to BBB – at *Standard & Poor's* and *Fitch* and from Aaa to Baa3 at *Moody's*). In the second instance it is deemed that there is a significant default risk (ratings ranging from BB+ to D at *Standard & Poor's* and *Fitch* and from Ba1 to C at *Moody's*).

The euro crisis provided the ratings agencies with a wonderful opportunity to improve their image that was damaged by the *subprimes* crisis. If the States pay off part of their debt, the agencies take advantage of their severe rating and deem that this had an undeniable effect in terms of creating a political response to the crisis. If however these countries find themselves in default long term the agencies' legitimacy is strengthened.

The crisis however has strengthened a certain amount of scepticism about the ratings agencies. It is suggested that they did not anticipate the downturn in the financial situation of a certain number of States. Once the crisis was there they attempted to make good their mistake by downgrading, rather too much and too late. Hence the agencies are seen to be pro-cyclical: they move in the same direction as the economy and may make the crisis worse.

- BOND

The bond is a debt security that enables a business or a State to borrow on the markets. The purchaser of this bond is paid interest in exchange: the coupon (interest) is paid at regular intervals (quarterly, six-monthly, yearly). The rate of this interest, set at the time of emission depends on the duration of the loan and the solvency of the issuer. The more this is limited the higher the interest rate.

- REFINANCING OPERATIONS

Refinancing operations by the European Central Bank should enable European banking establishments to ward off the risk of liquidity crises. The *Long term refinancing operation* (LTRO) programme enables them to borrow money from the bank long term (between one and three years) and at an advantageous rate: 1% whilst the market rate lies at around 3.5% over three years).

Two operations of this type have been undertaken so far, in December 2011 and February 2012. 523 banks raised 489 billion € in 2011. At the beginning of 2012, 800 banks raised 529 billion €. Although the principle of the LTRO's is not a novelty, the duration of the loans had been limited to one year up to that point. In the end the sums raised represent 72%of the total amount of bank bonds that reach maturity in 2012 and 2013.

- PRIVATE SECTOR PARTICIPATION

The difficulties encountered by Greece in guaranteeing the sustainability of its debt in spite of the first international bail-out granted in 2010 led the EU to involve private creditors in the second aid plan, decided upon in February 2012. According to this creditors were invited to extend maturity i.e. increase the time of reimbursement, and reduce interest rates on the securities they held. A discount on their securities was requested leading to the cancellation of part of the Greek debt.

The participation of private creditors responds to the goal of reducing Member States' contributions to the bail-outs granted to countries in difficulty – especially when the causes of the crisis lie in banking.

Hence the ECB said that it supported the idea that senior debt holders – who have to be reimbursed as a priority – should also make losses as part of the restructuring of the Spanish banks. The "legislative package" regarding the management of an establishment's bankruptcy, presented by the European Commission in June 2012 plans for the participation of senior creditors in the bank restructuring process as of 2018. Participation like this had been ruled out of the negotiations in the bail-out plan for Ireland in November 2011.

The Cypriot crisis demonstrated that depositors could also be drawn into bank restructuring measures since deposits over 100,000€ of the country's first two banks gave rise to an exceptional levy designed to foster the recapitalisation of these establishments.

- STOWAWAY

In economic terms a stowaway means that an actor obtains and benefits from an advantage achieved by a group without having invested as much as the other members of this group or without fulfilling the obligations associated with participation in the group. In the euro zone crisis this concept targets the States which have benefited from belonging to economic and monetary union (low interest rates notably) without implementing structural reforms or without setting budgetary discipline designed to guarantee these advantages.

- THE EUROPEAN CENTRAL BANK'S *OUTRIGHT MONETARY TRANSACTION* PROGRAMME (OMT)

Introduced in September 2012 the ECB's Outright Monetary Transaction (OMT) comprises the purchase of securities on the secondary market of State experiencing difficulties on the financial markets. The maturity of these securities varies between one and three years. The purchase of these securities is not limited quantitatively nor is there an intervention threshold. Many indicators are used: the spread, i.e. the difference between the rate applied to German securities and that applied to the bonds of the State involved in the purchase, the sovereign CDS level, as well as the liquidity and volatility of the markets.

This programme succeeded the *Securities Market Program* (SMP) which enabled the ECB to purchase 208.53 billion Greek, Irish, Portuguese, Spanish and Italian securities between May 2010 and March 2012, without requesting anything particular in exchange of the States in question. The OMT was not adopted unanimously by the ECB's Council of Governors. The German Bundesbank deemed that the OMT programme was a distorted way of financing public deficits.

The ECB's purchases are however conditioned by the introduction of structural reforms by the States in question. The ECB has taken up the principle of conditionality adopted as part of the re-purchase of securities by the ESM. The countries are placed under supervision and a quarterly report which helps the ECB decide on the continuation of purchases also has to be delivered. If these commitments are not respected the ECB can suspend its action.

- PROMISSORY NOTES

The *Irish Bank Resolution Corporation* (IBRC) was created in July 2011 to merge the *Anglo Irish Bank* (AIB) and the *Irish Nationwide Building Society* (INBS), which were both close to bankruptcy after the collapse of the Irish real estate bubble. These two establishments were nationalised respectively in 2009 and 2010 like most of the local banks.

To avoid the collapse of both establishments the government granted emergency aid totalling 31 billion € in the shape of *promissory notes*. This sum was supposed to enable them to refinance with the Central Bank of Ireland (CBI) and therefore with the ECB. These promissory notes were in fact the acknowledgement of debts underwritten by the Irish State: the Irish government has committed to reimbursing 3.1 billion € by 2031 on a yearly basis to the IRBC (31st March every year). This sum represents 2% of the Irish GDP. The promissory notes were used as "collateral" by the IRBC with the CBI, which in exchange provided emergency liquidities (ELA). 16 billion € in IRBC assets were also paid to guarantee the emergency liquidities which total 40 € billion; 6 billion € have already been reimbursed by the Irish authorities.

Since it took office in March 2011 the government coalition in Dublin has wanted to negotiate the reimbursement of the *promissory notes*, in order to relieve its refinancing requirements and to provide a better guarantee to its return to the markets planned for the end of 2013. To achieve this it has to come to an agreement with the Central Bank of Ireland and also as part of the European system of central banks, via the ECB. This agreement was met on 7th February last. It plans for the transformation of 25 billion € remaining promissory notes into 25 billion State bonds whose maturity ranges from 2038 to 2053. The interest rates of these bonds are estimated at 3% whilst those on the promissory notes rose to 8%.

- THE STABILITY AND GROWTH PACT

Adopted in 1997 the Stability and Growth Pact obliges EU Member States to respect two main criteria: a public deficit below 3% of the GDP and a public debt below 60% of GDP. In the event of excessive deficit an sanction procedure can be launched by the European Commission. The Council of Economy and Finance Ministers (Ecofin) then adopts recommendations vis-à-vis the State in question. If the excesses are confirmed the Ecofin Council can impose sanctions: a deposit of a sum with the ECB that might rise to 0.5% of the GDP of the State in question or a fine of an equivalent sum. 23 of the 27 Member States had an excessive deficit when the pact entered into force. Only Estonia, Finland, Luxembourg and the Netherlands respected the 3% criteria. Some States deemed the conditions rather too severe, including Germany and France. As a result the rule was reformed in 2005. Member States can now avoid an excessive debt procedure if they are in recession although until then this dispensation had only been granted to States suffering a severe growth crisis (loss of more than or the equivalent of 2 GDP points). The decision to launch an excessive deficit procedure is still only undertaken after the assessment of a certain number of "pertinent factors" (economic conditions, on-going reforms). The assessment deadlines have also been extended.

Adopted at the end of 2011 the "governance" or six-pack, steps up the supervision procedure and sanction mechanism. The countries involved will notably now have to reduce the difference between their debt level expressed by the GDP and the 60% threshold by 5% on average over three years. The Treaty on Stability, Coordination and Governance (TSCG) takes up some of these measures.

- Debt buyback

Debt buyback is one of the instruments available to the ECB and the ESM designed to reduce the interest rates of euro zone countries which are experiencing serious financial difficulties.

These purchases are undertaken on the secondary market. The Securities Market Program (SMP) enabled the ECB to acquire 208.53 billion Greek, Portuguese, Spanish and Italian securities between May 2010 and March 2012. In September 2012 it introduced a new sovereign bond system, the maturity of which ranges from one to three years (*Outright Monetary Transaction programme*). These purchases are now conditioned by the implementation of structural reform by the countries involved.

The ESM can also purchase a Member State's sovereign debt bonds on the primary or secondary markets. An ECB analysis established previously must justify this intervention. The State in question also has to sign a protocol agreement with the ESM which conditions these purchases to the introduction of structural reform.

The agreement of 26th November 2012 between Greece and its creditors enabled Athens to repurchase half of the securities acquired by private creditors, ie around 31 billion € discounted at 60%.

- RESTRUCTURING THE BANKING SECTOR

Restructuring the banking sector entails a series of operations that aims to respond to the difficulties of a State's financial establishments linked to their exposure to the sovereign debt – as in Greece – or the collapse of a speculative bubble – as in Cyprus, Spain and Ireland.

The series of measures is quite extensive: ranging from the containment of toxic assets and bad debts within a specialised organisation (bad bank) to the settlement (liquidation) of an establishment and also recapitalisation, nationalisation or the merger of several banks.

Since the start of the economic and financial crisis in 2008 the amount of public aid granted to restructuring totals 1,600 billion € in the EU. Increased creditor participation and even exceptionally that of depositors (as in Cyprus) should reduce this participation in the future. The restructuring of the banking sector is within the remit of the ESM. It is due to be supervised as of March 1st 2014 by the Single European Supervisory Mechanism (SSM), introduced as part of Banking Union.

- RESTRUCTURING THE DEBT

Restructuring the debt should help the issuer, a State for example, to curb the solvency crisis which it is facing. It can take several shapes:

• restructuring via the so-called "haircut" which supposes a discount in the value of the securities held by its creditors with or without their agreement. This solution was decided upon in February 2012 for Greece;

• restructuring via so-called soft or "re-profiling" procedures which associates the extension of the Greek sovereign bonds and the reduction in interest rates. This solution was also opted for as part of the second bail-out to Greece in February 2012.

• re-scheduling supposes a maturity extension on debt securities without the reduction of interest rates.

- EUROPEAN SEMESTER

Introduced in 2011 the "European Semester" comprises a period of time designed to assess the budgetary guidelines of every Member State but also the economic and structural reforms it is implementing to improve the coordination of the economic policies of the 27 Member States and to foster the convergence of economic results.

In January the European Commission publishes its annual growth assessment and sets the EU's priorities to stimulate growth and employment over the year to come. This document is used by the Heads of State and government in March as they gather for the European Council to adopt the EU's guidelines for national economic policies. Member States present their stability and convergence programmes in April which are designed to guarantee the sustainability of public finance and also their national reform programmes that aim to help towards intelligent growth that will foster employment thereby responding to the Europe 2020 strategy. These programmes are assessed in June by the European Commission that can, if need be, make specific recommendations to each State. They are then submitted to the European Council at the end of June. The States involved must take on board the recommendations as they draft their budget for the following year in the autumn.

- *SIX-PACK*

The *six-pack* is a "legislative package" comprising five rules (direct application) and a directive adopted in December 2011 which modifies the preventive and corrective chapters of the Stability and Growth Pact which entered into force in 1997.

The excessive deficit procedure now targets a State whose debt is over 60% of the GDP even if its deficit is below 3%. The difference between its debt level and the 60% threshold must also be reduced by 1/20 yearly.

The Member States undergoing an excessive debt procedure are now obliged to fall in line with the specific recommendations addressed to them by the Council. Financial sanctions are planned for euro zone Member States. These vary ranging from the deposit of a sum equivalent to 0.2% if the State's GDP to a fine. In order to gain dispensation from this sanction a State will have to rally a qualified majority (the opposite of the qualified majority).

The preventive chapter of the Stability and Growth Pact now sets specific medium-term budgetary objectives (MTO) for the Member States aiming to ensure the sustainability of public finance. Again a fine system has been introduced in the event of any major deviation from the execution of the budget.

The package also introduces an excessive imbalance procedure designed to pinpoint a certain number of risks that weigh over a Member State's economy: competitiveness deficit, speculative bubble, private debt, etc. 10 indicators have been selected to this effect. The Council can address recommendations to the States in question. Financial sanctions are planned for vis-à-vis the euro zone States which do not apply them ranging from the deposit of a sum equivalent to 0.1% of the GDP to a fine.

- STRUCTURAL BALANCE

A State's structural balance is the balance between the revenues and spending of a State, its local communities and social security organisations, corrected by measures adopted to face the economic situation: an increase in unemployment compensation in times of crisis for example.

The Treaty on Stability, Coordination and Governance (TSCG) stipulates that the structural deficit shall not rise medium term beyond 0.5% of the GDP in each State.

- SOLVENCY

The idea of the solvency of an economic actor entails its ability to pay its debts or overcome an unplanned event (non-reimbursement of a loan that it is granted or the loss in value of one of its assets). The solvency of a business or a bank depends on the volume of its own funds.

Three directives on own-fund requirements, the so-called CRD 1, 2 and 3, (Capital Requirement Directive) adopted between 2006 and 2010 oblige the respect of own-funds ratios on the part of the banking establishments. The Solvency Directive adopted in 2009 introduced similar requirements in terms of the insurance sector. These ratios were defined previously by the Basel Committee on Banking Control, which is hosted by the Bank for International Settlements (BIS). These ratios are supposed to prevent bankruptcy and curb the effects on a country's economy. A draft CRD Directive 4 plans to step up these ratios. It is under negotiation at the moment.

- PUBLIC FINANCE SUSTAINABILITY

A State's public finances are only sustainable if there is adequate budgetary capacity to honour commitments. The public debt is deemed unsustainable if its interest rates rise significantly and its debt levels rise at the same time. Hence if the rates of a State's 10 year bonds rise over 7% the debt progressively becomes unsustainable. The increasing costs of financing the latter force the State to raise further levies that will impede growth. In the end this means a decrease in fiscal revenues and further difficulties in respecting the deadlines to reimburse the debt.

The sustainability of public finances is measured via the level of debt and the ability to achieve a primary budgetary surplus, ie before servicing interest on the debt, which prevent debt levels from rising. Various additional factors are also used to assess a State's situation: private debt, share of the public debt held by inhabitants, the influence of social transfers linked to unemployment insurance schemes and the ageing population.

- SPREAD

The *spread* comprises the difference between two rates: that of the bond issued on the market and that of a loan deemed to be without risk. The *spread* is supposed to define the solvency of the issuer. The higher it is, the more relative it is deemed.

In the sovereign debt crisis it has enabled the comparison on the secondary market of the differential between Germany's 10 year sovereign bond rates, the State that borrows at the lowest rates, and that of other bonds of similar maturity on the part of a country in difficulty.

- *TASK FORCE*

The European Commission's *task force* in Greece was launched in July 2011. It is supposed to help with the implementation of structural reform in Greece, draft projects with local authorities in order to benefit from the structural funds that it is entitled to and take part in the modernisation of the local civil service; notably in terms of taxation. It was strengthened in February 2012 when it opened an office in Athens.

Comprising 45 staff, as well as 10 national experts, it operates under the authority of the President of the Commission and works under the guidance of the Vice-President of the Commission responsible for economic and monetary affairs. It presents quarterly reports to the European Commission and to the Greek authorities.

- FINANCIAL TRANSACTIONS TAX

Presented on 28th September 2011 the draft directive on the common tax on financial transactions is deemed to be a response the financial crisis of 2008: since speculation is seen to be one of the reasons behind this imbalance. It advocates the implementation of a wide ranging tax since it applies to all transactions between financial institutions (banks, hedge funds, stock exchanges, insurance companies, investment companies), if one of the financial institutions is established with the EU (the so-called residency principle). Two types of market are targeted by this measure: that of stocks and shares, within which every transaction would be taxed to a total of 0.1% and that of the derivated products market, that functions on the short term and within which profits are deemed low – transactions in this market would be taxed to a total of 0,01%.

Because no agreement was found between the Member States on the advisability of this measure 11 Member States (Germany, Austria, Belgium, Estonia, Spain, France, Greece, Italy, Portugal, Slovakia and Slovenia) were allowed to establish an enhanced cooperation agreement on 22nd January 2013 in order to test out this levy. The new draft tax presented on 14th February 2013 integrates the British principle of the place of emission: the tax will apply to financial institutions outside of the European Union which will be obliged to pay this tax if they have negotiated bonds issued within the European Union. The tax could bring in between 30 and 35 billion €, against 57 billion if it were applied by all 27 Member States. The question of how the funds collated are to be used has not yet been decided, since Germany is against paying this sum into the EU's budget. The timescale retained by those advocating the tax comprises entry into force in 2014.

- TREATY ON STABILITY, COORDINATION AND GOVERNANCE (TSCG)

Signed by 25 EU Member States (except for the UK and the Czech Republic) the Treaty on Stability, Coordination and Governance, or the European Budgetary Pact entered into force on January 1st 2013, after its ratification by 12 euro zone Member States. On 29th March 2013 20 countries had ratified it, including 13 in the euro zone. It mainly aims to strengthen coordination of budgetary policies of the States taking part and to improve euro zone governance.

The Treaty's main innovation comprises the introduction into national constitutional legislation of a budgetary "golden rule" whose rules deem that the structural deficit of the Member States must not rise over 0.5% of their GDP. The 0.5% threshold is not obligatory immediately. Indeed the rule is deemed to be respected if the annual structural deficit matches the forecasts made by the government and communicated to the Commission via the four yearly stability programme. This programme sets a medium-term objective (MTO) defined in terms of the structural balance. The Treaty now means that the MTO has to lie between 0.5 GDP points and a surplus.

Exceptional circumstances, independent of the States, allow them to deviate from the golden rule. A serious recession would be taken into account. The Treaty does not detail the nature of these "unusual" circumstances that might seriously affect a State's financial situation.

The supervision of the implementation of the budgetary balance rule is to be undertaken by an independent, national organisation, whose existence was already mentioned in the two-pack. The insertion of the golden rule in the Member States' legislation can be checked by the EU's Court of Justice and if transposition has not occurred a fine can be set.

The TSCG also takes up a measure in the six-pack whereby euro zone Member States whose public debt rises beyond 60% of the GDP (12 States of the 17 at the moment) must be reduced by 1/20th per year.

The Treaty also strengthens the application of the Stability and Growth Pact obliging a State to enjoy a qualified majority in order to be able to be dispensed from the rules contained in the treaty.

The Treaty institutionalises euro zone governance by creating euro zone summits that will take place twice yearly, by including the election of the said summits and by drafting the main guidelines of parliamentary supervision of the Treaty's application via a conference that rallies MEPs and national parliamentarians.

- TROIKA

The troika brings together representatives of the European Commission, the European Central Bank and the IMF who are responsible for defining a country's financial requirements if it has requested financial assistance, then for supervising the means for the implementation of these. The troika notably assesses the implementation of structural reform included in the Memorandum of Understanding signed by the parties receiving the loan. Its appreciation of the situation is then communicated to the creditors who accordingly decide on the payment of a tranche of aid.

- *TWO-PACK*

The *two-pack* is a "legislative package" comprising two rules designed to strengthen the EU's supervision of national budgets and to strengthen the supervision of the States encountering difficulties. It completes the six-pack and the "European Semester". It is due to enter into force mid-2013.

As part of the European Semester the States now have to communicate a medium-term budgetary plan which is supposed to replace the Stability and Convergence Programme.

The package insists that the Member States' have to establish an independent national body responsible for supervising the respect of the medium-term budgetary objective; this institution was already an element in the European Treaty on Stability, Coordination and Governance.

The package should enable the European Commission access to the draft budget for the year to come of each Member State as of 15th October – before this is submitted to Parliament. It will then check that the States are respecting the recommendations adopted as part of the European Semester, otherwise sanctions will ensue.

Moreover the Commission can suggest greater supervision to a country which is exposed to serious financial difficulties or which is already the subject of an EU bailout plan. This decision is then taken by the Council with a qualified majority. After consultation with the Commission and the ECB a State in this situation will have to adopt measures that aim to remedy the causes of its problems and it will also have to deliver a quarterly report. The Commission will also have access to the banking sector's accounts and information resources.

- BANKING UNION

The euro zone crisis is partly linked to the difficulties encountered by a certain number of financial establishments in Spain, Ireland and Cyprus. It was in this context that the European Council dated 28th and 29th June 2012 formalised the principle of strengthening banking supervision Europe wide, as part of Banking Union.

An agreement was reached on 13th December 2012 in view of establishing a Single European Supervisory Mechanism (SSM) on March 1st 2014. The SSM will comprise representatives of the national banking authorities and the ECB. It will supervise around 200 banks: those whose assets are over 30 billion €, those which represent more than 20% of a State's GDP in which they are established, as well as those that are already benefiting from European aid, like the Spanish establishments for example. Supervision will apply to euro zone Member States. The banks in the other countries can join if they wish. The UK, the Czech Republic and also Sweden have said they wish to remain outside of this field of supervision.

The supervisory mechanism is just a first step which is due to be completed by the introduction of a system to prevent and settle crises and by the pooling of banking debts, as part of single deposits guarantee system.

- BUDGETARY UNION

In June 2012 the 27 heads of State and government asked the presidents of the European Council, the European Commission, the European Parliament and the ECB to put forward ideas to strengthen Economic and Monetary Union (EMU).

The interim report put forward by the President of the European Council in October 2012 advocates the creation of a budgetary organisation that would have borrowing capacities. The ensuing European budget would finance structural and competitiveness reforms implemented by the Member States to overcome the crisis. The document also mentions two budgetary solidarity instruments that might be used by EMU to solve refinancing issues on the markets which are experienced by some Member States: the emission of eurobills, short-term common bonds and the creation of a redemption fund that would manage the share of the Member States' debt that surpassed 60% of their GDP.

The European Council dated 13th and 14th December 2012 did not follow up on this project. The Presidents of the European Council and the Commission are to put forward a new roadmap in June 2013 in view of fostering greater coordination between economic policies and introducing competitiveness and growth contracts between the EU and the Member States. A European fund that is provided with 10 to 20 billion € would be established to encourage the signature of these contracts.

- OPTIMAL MONETARY ZONE

Put forward by the American economist Robert Mundell the theory of optimal monetary zones defines the criteria to fulfil for States to achieve viable economic and monetary union. The Nobel Prize Economy Prize Winner 1999 retained two of these:

• the absence of asymmetric shock in the euro zone, a shock being deemed asymmetric if it affects a part of a zone and not another;

• the mobility of production factors: the labour markets and capital have to be sufficiently flexible in order to respond to the crisis.

Other economists have completed this theory by promoting other factors designed to guarantee the optimum nature of monetary union: diversity of the productive network, openness of the economies and the creation of a federal budget. These three factors should help to compensate for any asymmetric shocks. For the time being the euro zone is far from forming an optimal monetary zone. The EU's budget is reduced to a minimum and worker mobility is still low. Moreover there is no common economic model: export countries (Germany or the Netherlands) contradict the States whose main economic activity is based on consumption. The euro crisis highlights just a little more the importance and repetition of asymmetric shocks.

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