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Europe must prepare an emergency plan

By Robert Zoellick

Eurozone leaders may be nearing a "break the glass" moment: when one smashes the pane protecting the emergency fire alarm. While those living in the eurozone building, especially those on the executive floors, will not want to hear an alarm, they had best read the instructions. Events in Greece could trigger financial fright in Spain, Italy, and across the eurozone, pushing Europe into a danger zone.

The summer of 2012 offers an eerie echo of 2008. Markets are signalling anxieties about a major asset class. In this round, eurozone sovereign debt has replaced mortgages as the risky investment. Banks are under stress. Depositors have not yet begun to run, but they are starting to jog. The European Central Bank, like the US Federal Reserve in 2008, has sought to reassure markets by providing generous liquidity, but collateral quality is declining as the better pickings on bank balance sheets are used up.

We cannot predict the outcome of the Greek election, nor whether a new Greek government will simply drive a harder bargain for more subsidies, rather than seek to leave the eurozone. Greece's eurozone partners are frustrated, although they still seem willing to offer considerable aid to avoid a crisis precipitated by a Greek exit from the euro – if Greece's leaders and public commit to a viable programme.

If Greece leaves the eurozone, the contagion is impossible to predict, just as Lehman had unexpected consequences. A Greek exit would trigger a hit to confidence in other sovereign euro assets. Eurozone leaders need to be ready. There will not be time for meetings of finance ministers to discuss the outlook and debate the politics of incrementalism. In panicked markets, investors flee to safe assets, sparking other flames.

Some argue that if a crisis begins the ECB can overwhelm it. Yet the differences of views on the ECB board raise doubts about its ability to respond fast, fully, and forcefully. Moreover, the states that stand behind the ECB would have to decide to permit it to provide further funds to banks with poor collateral, or those that flirt with insolvency. Eurozone leaders need to be prepared – psychologically and through the European Stability Mechanism – to recapitalise banks.

Even massive injections of ECB liquidity may not be enough. When I ask developing-country veterans of financial panics what advice they would offer, their response is uniform: governments have to guarantee bank deposits and probably other liabilities. In the eurozone, the guarantees of some national sovereigns are unlikely to be sufficient and only that of the "euro-sovereign" will suffice. It is far from clear that eurozone leaders have steeled themselves for this step.

After Lehman's collapse, the illiquidity began to choke the corporate sector, too. Major companies feared they could not get bank loans or roll over commercial paper. Bankruptcies loomed.

Eurozone banks have spent three years under pressure to deleverage, build capital, and reduce risk. I doubt that the first instinct of their executives in a crisis will be to pump out loans to business borrowers. But if we wake up to news of a major corporate bankruptcy, lenders and savers may pull back just as they would from a blow to banks.

When financial markets get anxious, peril often strikes two or three links down the financing chain. So eurozone leaders need to be monitoring liquidity risks in the corporate sector. And if banks get emergency assistance, bank executives will need to be pressed to keep providing customers with cash.

No one wants to have to act on the "break the glass" instructions. But it is wise to read them and to be prepared. The seriousness of the emergency steps should encourage eurozone leaders to take precautions – such as getting ESM capital into banks now and agreeing on a medium-term funding assurance for countries such as Spain. This assurance could come from the ESM or partial deployment of eurozone bonds in ways that maintain market discipline on state financings.

This recommendation does not conflict with Germany's call for fiscal discipline and microeconomic reforms. Those steps must be taken. Germany has understandably been unwilling to turn on its fiscal tap unless those reforms are realised. Yet Germany will not achieve its strategic aims of a more integrated and fiscally sound eurozone unless it supports reforming states and prepares for contagion. Good leaders anticipate. They ready themselves to move quickly – and seize the moment to further larger ends.

The writer is president of the World Bank Group

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