

## An agenda for the European Council Feasible steps to bring the eurozone back from the precipice

Stefano Micossi

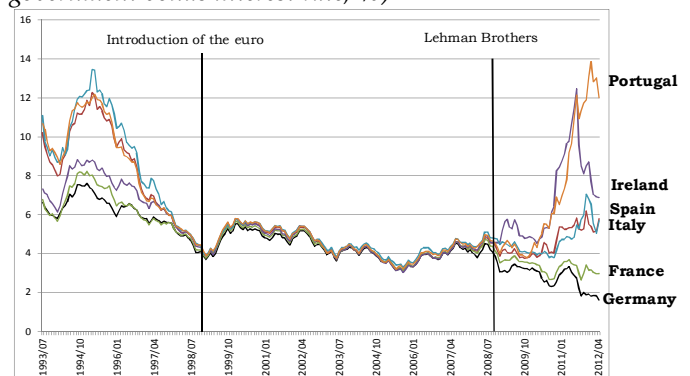
No. 274, June 2012

Once again the European Council will meet in an emergency session at the end of June, with the eurozone economy in recession and actually plummeting in its Southern periphery. Further doubts are also growing on the sustainability of sovereign debts due to the vicious spiral of deteriorating bank balance sheets, ballooning potential liabilities from banking rescues and widening spreads on government borrowings. The sovereign debt crisis in the periphery has now turned into a fully fledged banking crisis that threatens to spread from Greece to Spain and tomorrow, who knows, to Italy, France and even Germany itself.

Figure 1 provides a vivid picture of the situation: the constellation of spreads on ten-year sovereign debts over the Bund in the eurozone is wider than it was before monetary union, as if financial markets already discounted its breakdown. Temporary respites, as notably in the early part of 2012, have not interrupted a trend of increasing divergence that is already undermining the credibility of adjustment efforts under way. Private capital flows from the core to the periphery have dried up and banking and financial markets are segmenting along national lines, with much of the burden of financing payment imbalances and keeping credit channels open increasingly falling on the ECB. Not

surprisingly, this does not reassure savers and investors, who increasingly are resorting to emergency protective behaviour, liquidating their holdings of Southern securities and hoarding liquidity, sometimes straight currency notes, as the confidence crisis in the banking system spreads from one country to another.

Figure 1. Eurozone bonds back to pre-euro levels (10-year government bonds interest rate, %)\*



\* Monthly data.

Source: ECB.

Against this background, the public statements of the leaders and heads of institutions are not helpful since they suggest a climate of brinkmanship and division rather than constructive engagement. On the one hand, many of the demands directed at Germany, the eurozone anchor, seem unrealistic, at least under present institutional arrangements. Germany's

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reaction, under pressure from public opinion, is to stress the red lines that cannot be trespassed rather than what could be usefully done. On the other hand, neither can high debt-low growth countries be expected to meet their adjustment obligations regardless of the economic environment and the behaviour of creditor countries. Nor will financial markets stabilise without a firmer commitment and stronger action by the ECB to halt sliding sovereign prices. Thus, here we are once again hoping that the European Council may be able to square the circle and come up with a policy package able to halt a seemingly inexorable slide towards total disaster – and the most likely outcome of another patchwork of soothing announcements, half-baked measures and conflicting interpretations *post factum*.

This Policy Brief discusses the main elements of a realistic and yet incisive policy package, capable of reassuring financial markets and a bewildered public opinion. It is more than Germany has been willing to accept so far but much less than the many demands it will confront at the Council meeting. More importantly, it only requires a minimum of additional disbursements by the member states, while strengthening risk-sharing for sovereign and banking risks.

### 1. The need for a renewed growth initiative

There is, first of all, a paramount need of a stern and credible announcement that stronger economic growth is a shared goal and that the European Council and the member states are ready to take measures to stem the fall in activity and raise aggregate demand. To be sure, these measures should in no way weaken structural budgetary consolidation and market reforms, but exclusive emphasis on the supply side, as in the European Council March statement, simply will not suffice.

A main manifestation of declining confidence is activity falling more rapidly than expected in countries undertaking tough adjustment programmes to restore sustainable budgetary and competitive positions, dragging down also the ‘core’ economies and pushing the entire eurozone into recession (see Table 1, particularly the last column for latest estimates). This development has been partly due to an underestimation of the recessionary effects of budgetary austerity applied simultaneously throughout the eurozone, and

partly to the impact of the spreading banking crisis on the supply of credit.

Table 1. GDP growth, 2012 (%)

	European Commission	IMF	Latest
France	0.5	0.5	-0.1
Germany	0.7	0.6	-0.1
Greece	-4.7	-4.7	-5.7
Ireland	0.5	0.5	0.4
Italy	-1.4	-1.9	-2.3
Netherlands	-0.9	-0.5	-0.7
Portugal	-3.3	-3.3	-3.5
Spain	-1.8	-1.8	-2.2
Euro area	-0.3	-0.3	-1.0
UK	0.5	0.8	-0.2

Source: European Commission 2012 Spring Forecast. IMF WEO April 2012 and author's own estimates.

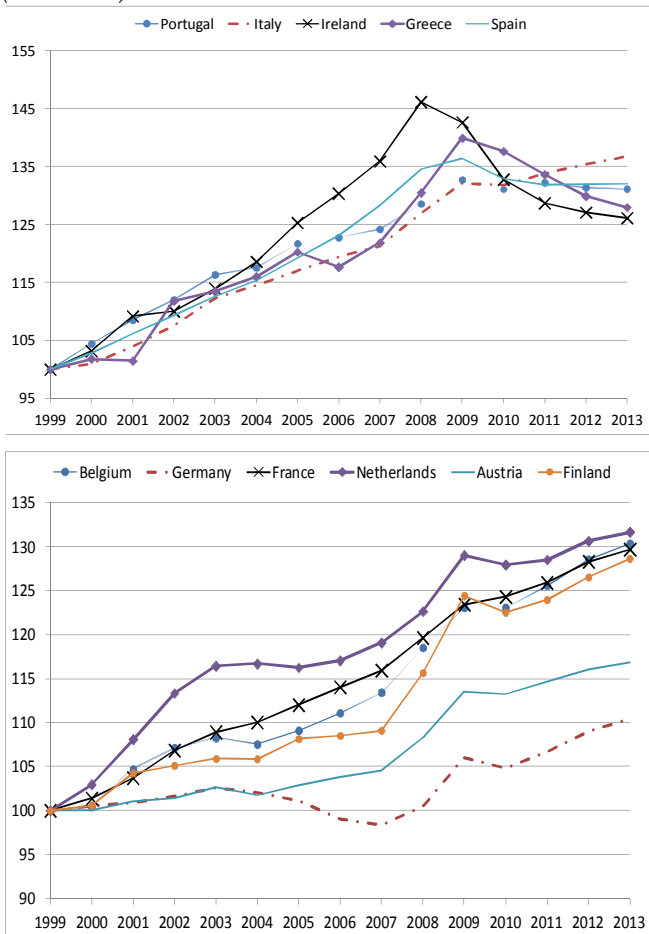
In this regard, a comparison with the successful frontloaded adjustment stories of the Baltic countries, notably Latvia, should not overlook the fact that those countries were able to count on expanding markets for their exports in Northern Europe, as well as an effective backstop for their banks by Sweden – both elements notably missing in the eurozone Southern periphery. Moreover, in Latvia, domestic demand recovered fairly fast thanks to rapid productivity increases, but these were easier to achieve in a country with per capita GDP half that of the European Union.<sup>1</sup>

True, the eurozone's weak economies have yet quite some distance to go with their ‘internal devaluations’ to restore viable competitive positions – even if progress in Ireland and Greece on this front has been substantial (see Figure 2, upper quadrant). Once again, however, one should not forget that a substantial deterioration in competitive positions vis-à-vis Germany was also experienced by all other members of the eurozone, including Austria, Belgium, Finland, France and the Netherlands (Figure 2, lower quadrant), which remains as a source of deflationary pressures throughout the eurozone. It is also reflected in persistently large imbalances in current external payments, which under current policies will be corrected too slowly to avoid an unsustainable accumulation of foreign debt (see

<sup>1</sup> O. Blanchard, “Lessons from Latvia”, VoxEU, 15 June 2012.

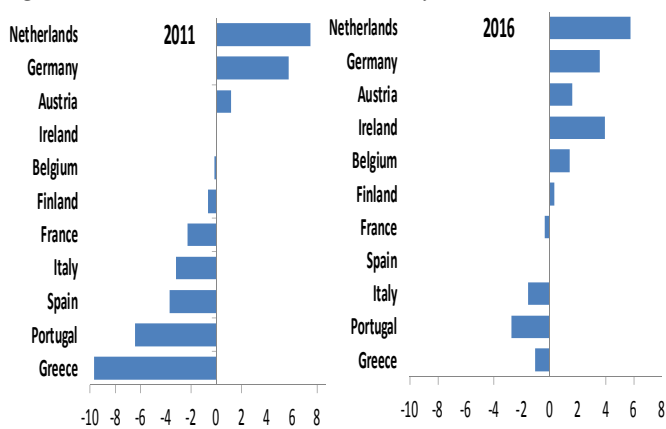
Figure 3) or, if financing dries up, even more deflation in deficit countries. Adjustment, moreover, has not been facilitated by the strength of the euro, in turn a result of a monetary policy stance by the ECB that is systematically more cautious than that of the US Federal Reserve.

Figure 2. Unit labour costs in PIIGS and core countries (1999=100)



Source: European Commission, Ameco, 2012.

Figure 3. Current account balance (% of GDP)



Source: IMF WEO, April 2012

In sum, unchanged policies hold the threat of further deflation down the road. There is a need to accelerate structural reform but also investment to support domestic demand in the eurozone, and

budgetary retrenchment should not be pushed beyond the point of becoming self-defeating. Much of what needs to be done is well identified by the recent Commission communication “Action for Stability, Growth and Jobs”.<sup>2</sup> The main recommendations include the following (my rephrasing and order of priority):

- i. To step up implementation of the internal market in energy, transport and communications (notably broadband);<sup>3</sup> I would add that the European Council should make the member states’ obligations in this area part of the broad economic policy guidelines procedure of Art. 121 of TFEU, with attendant sanctions for failed implementation.
- ii. To mobilise all available funds at Community level in support of infrastructure investment for the internal market, including by immediately starting the project bond pilot phase,<sup>4</sup> and raising substantially – by at least €20 billion, which is double the Commission proposal – the paid-in capital of the EIB, thus greatly enhancing its lending capacity for

<sup>2</sup> COM(2012) 299 of 30.5.2012, final.

<sup>3</sup> An influential strand of thought maintains that infrastructure investment does not improve productivity, mainly based on the US experience of strong growth with poor road and rail networks and dismal public utility services. The European variant has it that Europe already has all the infrastructure that it needs and that further investment would be wasted. This view seems unconvincing. For instance, recent research on a large sample of countries reported in VoxEU (“Fiscal spending and growth: More patterns” by C. Carrière and J. de Melo, 17 May 2012) finds that a shift in discretionary expenditures towards transport and communications “was only observed for fiscal events followed by growth events” (p. 2). In many an EU country, including Italy and Germany, over the past decade public investment has been low, sometimes below what was needed solely for depreciation and maintenance. Moreover, the creation of a functioning market for gas and electricity and for digital services requires large, and surely profitable, investment to establish the connections between segmented national markets – investment that was held back by national monopolists and that is a source not only of higher prices and lost productivity gains, but in the case of gas also of a dangerous concentration of supply with a politically unreliable partner such as Russia.

<sup>4</sup> As described in the Commission communication, “A pilot for the Europe 2020 Project Bond Initiative”, COM(2011) 660 final of 19.10.2011.

worthy Community priorities. Given the excellent record of EIB lending, the money spent through this channel will bring good returns to its shareholders and does not entail higher overall indebtedness by the member states.

- iii. To clarify and announce that budgetary deficits due to larger-than-expected drops in economic activity needn't be offset by further restrictions, as permitted by the revised Stability and Growth Pact. In the case of Greece and Spain, in view of the dismal output and employment performance, the Council should ease budgetary targets, which under current economic circumstances are simply unfeasible (more on this later in Table 3).

Regarding this last point, in order to preserve the confidence of investors, a number of eurozone countries must strike a difficult balance between budgetary austerity and the need to avoid an economic overkill that would frustrate budgetary consolidation.<sup>5</sup> This difficult balancing act would be facilitated by a clear statement by the European Council whereby letting automatic stabilisers work, while remaining on track with 'structural' budgetary targets, fully complies with EU policies and obligations.

The prime minister of Italy, Mario Monti, has also proposed to exclude certain public investments from the balanced budget rule. The proposal should not be too difficult to accept to the extent that the return on those investments is sufficient to cover interest costs and the repayment of principal. If, on the other hand, an element of subsidy is required, this should be included in current spending and the budgetary balance.

In this context, a greater share of the adjustment burden must fall on Germany through 'internal revaluation' and stronger stimulus to domestic demand, lest the correction of imbalances adds further to the deflationary forces already present in the eurozone.<sup>6</sup> Recent fairly generous wage

<sup>5</sup> C. Cottarelli, "The austerity debate: Festina lente!", VoxEU, 20 April 2012.

<sup>6</sup> In 1999-2007, Germany engineered a significant 'internal' devaluation that contributed to its economic recovery and the build-up of its external surplus; subsequently, there has been little change in relative competitive positions within the eurozone, with the sole exception of Greece and Ireland, as was recalled

agreements in Germany will help but are not enough; there is also a need to step up support of domestic demand. More aggressive liberalisation of the bloated banking system, network services, especially in energy and transport, and public procurement may provide over time a significant contribution to raising domestic investment and incomes. The sizeable investments required to make up for the loss of nuclear energy may contribute more immediate stimulus. All this should not be seen as a concession but must be recognised as part of the obligations undertaken by eurozone governments with the new procedure for excessive imbalances, although so far the Commission has somewhat shirked its responsibility to apply it even-handedly.<sup>7</sup> Germany should be convinced that without its own contribution in reviving growth and correcting external payment imbalances, the eurozone will not escape prolonged depression and, in all likelihood, will be doomed.

## 2. Monetary policy

The growth initiative badly needs the monetary support by the European Central Bank. Much in line with the tradition of the Bundesbank, the ECB has tended to interpret its mandate for price stability more as a cap on inflation - no higher than 2% - than a symmetric obligation to act also to correct inflation shortfalls, and has been reluctant to intervene in support of economic activity.<sup>8</sup> Conversely, in the United States and elsewhere, monetary authorities have turned on the money spigot much more aggressively to break the fall of economic activity and facilitate balance sheet deleveraging by households,

(see. De Grauwe, "In search of symmetry in the Eurozone", CEPS Policy Brief No. 268, May 2012).

<sup>7</sup> Report from the Commission, "Alert Mechanism Report. Report prepared in accordance with Articles 3 and 4 of the Regulation on the prevention and correction of macro-economic imbalances", COM(2012) 68 final of 14.2.2012.

<sup>8</sup> Under Art. 127 of the TFEU, "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies of the Union ...". And the Governing Council of the ECB stated, in October 2008, its intention "to maintain inflation rates at levels below, but close to, 2% over the medium term". Thus, the Treaty and the statutes of the ECB do not prevent it from acting more vigorously in support of economic activity, should the need arise.

corporations and the financial system. As a consequence, in the aftermath of the 2007-09 financial crisis, the euro has remained strong, probably too strong, vis-à-vis the dollar and the other main currencies (including the UK pound), adding further to deflationary forces and ‘boxing’ within the eurozone the external payment imbalances. As of late, the euro-dollar exchange rate has weakened to around 1.25, more as result of market concerns about the future of the currency than the monetary stance; a further weakening into the 1.10 region would be very welcome news for eurozone exporters and economic activity.

Meanwhile, inflation in the eurozone is receding to the 2% target and is widely expected to fall below it around year end. In view of the dire state of economic activity and the long time-lags between monetary stimulus and economic effects, it is high time for the ECB to lower their policy rates to zero. Moreover, not only do the ongoing liquidity shock hitting the eurozone and the need for the banking system to proceed with deleveraging<sup>9</sup> fully justify a continuation of the unlimited provision of liquidity, including the LTROs, but serious consideration should be given to quantitative easing through purchases of long-term sovereigns. This latter action should also aim to cap interest rate spreads as a bridge to calmer financial market conditions, providing markets with a temporary anchor until they will recognise the progress under way in budgetary stabilisation and structural reform.

If stabilisation of financial markets succeeds, the ECB is likely to earn hefty profits; however, the ECB should continue to enjoy a full, albeit perhaps not explicit, guarantee that any losses on its sovereign portfolio deriving from restructuring operations would be borne by the member states through the EFSF and, soon, the ESM – as happened with the Greek sovereign restructuring.

Monetary policy matters are not for the European Council to decide; they could, however, be discussed with the ECB President Mario Draghi. The ECB would no doubt feel freer to act, were it less subject to political pressure to exercise restraint from its German and Northern European members.

<sup>9</sup> C. Pühr, S. W. Schmitz, R. Spitzer and H. Hesse, “Room for maneuver: the deleveraging story of Eurozone banks since 2008”, VoxEU, 14 June 2012.

### 3. Bank restructuring and banking union

In the beginning, it was a small-country debt crisis, gradually transformed by contagion into a eurozone sovereign debt crisis threatening to topple Spain and Italy. Later on, it has evolved into a banking crisis that, unless it is stopped, could soon spread to all banking markets in the European Union and break the euro, with devastating economic dislocations.

The immediate cause, as cross-border interbank flows between creditor and debtor countries have shrunk to a trickle, has been the growing concentration of sovereign debt with national banks in crisis countries – facilitated by carry trade operations that banks undertook in a large-scale with ECB LTRO funds to repair their damaged balance sheets.<sup>10</sup> As a consequence, most private holdings of Greek public debt are now concentrated with Greek banks, and more than half of public debt in Spain is held by Spanish banks.

The vicious spiral between the sovereign debt and banking crises has been compounded by the decision, first taken in Europe by Ireland, and later followed in Spain’s Bankia crisis, to make good all banks’ private creditors and shift the burden of rescues onto the public budget. Fears of a repeat of the post-Lehman disaster have been one reason; another has been pressure by creditor countries to spare their banks from any losses on their exposure. Thus, as the sovereign debt crisis has deepened, banks’ ratings are lowered; as the banks face the prospect of growing losses on their government securities, financial markets raise estimates of potential losses and attendant capital injections, which are immediately computed as larger government debt.

The Eurogroup statement on Spain’s request for financial assistance for its banks of June 9<sup>th</sup> has made this dangerous interconnection an official policy: “The Eurogroup considers that the Fund for Orderly Bank restructuring (FROB), acting as an agent of the Spanish government, could receive the funds and channel them to the financial institutions concerned. The Spanish government will retain the full responsibility of the financial assistance and will sign the MoU.”

A better alternative, rightly advocated by the French government, would have been to use the

<sup>10</sup> D. Wessels, “Risks Rise as Europe’s banking Ties Fray”, *Wall Street Journal*, 14 June 2012.

EFSF residual funds – which are in excess of €200 billion (see Table 2) – directly to inject capital into Bankia and, if need be, into other Spanish banks running into trouble.

Table 2. EFSF assistance programme, as of May 2012 (€ billion)

Country	Agreed amount	Disbursed	Period covered by the assistance	Other partners
Ireland	17.7	12	2010-13	IMF, EFSM and bilateral loans by the UK, DK & SWE
Portugal	26	9.6	2011-14	IMF and EFSM
Greece II	179.7	103.7	2011-15	IMF

**Remainder for utilisation: €216.7 billion**

Source: A. Casale et al., “The implications for the EU and national budgets of the use of EU instruments for macro-financial stability 2012”, paper requested by the European Parliament's Committee on Budgets, forthcoming.

This would have effectively severed the pernicious spiral between the government and banking solvency crises, with immediate beneficial effects on confidence. A non-negligible benefit of using the EFSF would be to avoid creating a new class of super-senior claims on the Spanish Treasury, which would inevitably accelerate the flight to safety of junior creditors.

This approach requires two further conditions. The first is that conditionality imposed on banks requiring help be negotiated directly by the EFSF, with the assistance of the ECB. The ECB should be given full supervisory powers to ascertain their true conditions, verify compliance with agreed restructuring measures and, in case of non-compliance, resolve the bank. These powers could be entrusted to the ECB by the European Council under Art. 127.6 of TFEU; it would set a useful precedent for a gradual extension of similar powers over all cross-border banks with a legal seat in the European Union.

The second condition is that the shareholders and creditors of banks seeking assistance should take their share of emerging losses. To this end, first,

rather than debentures, the EFSF should receive (non-voting) preferred shares of the bank under rescue, at minimal cost (the EFSF borrowing cost plus a fee), redeemable within three years. Should the bank fail to redeem them, they would become full voting shares and the EFSF would take over the bank. This approach has the advantage of giving shareholders a chance to restore the bank to health and avoiding immediate nationalisation – as in the US post-Lehman experience. Moreover, as suggested by the Juan de Mariana Institute,<sup>11</sup> subordinated and senior unsecured creditors of the banks should be called to a forced debt-for-equity conversion; rather than to reduce the size of the initial capital injection by the EFSF, this could help strengthen the bank's capital position later on and facilitate the redemption of the preferred shares.

The Institute has calculated that there are in the Spanish banking system about €88 billion of subordinated liabilities and another €160 billion of senior unsecured debt. With conversion rates of 100% for the former and 40% of the latter, there would be some €150 billion available – up to €175 billion if expected profits were added in – to recapitalise the Spanish banking system, thus covering even the highest estimates of potential losses without increasing the burden on Spanish taxpayers. Since depositors would be unaffected – the private interbank market is already closed to Spanish banks and conversions would take place as part of well structured bank rescue operations – the impact of forced conversions on financial markets would in all likelihood be manageable.

In sum, the European Council should change the tack imprudently taken by the Eurogroup and put efficiency above expediency in managing the Spanish banking crisis. The same applies to Greece, where the EFSF/ESM should step in, wipe out existing shareholders and assume full control of the banking system.<sup>12</sup>

The agenda of the European Council is likely to include the broader theme of the banking union. In this regard, as argued in a recent CEPS

<sup>11</sup> J.R. Rallo, “A Better Way to Save Spain's Banks”, *Wall Street Journal*, 15-17 June 2012.

<sup>12</sup> D. Gros and D. Schoenmaker, “Cleaning up the mess: Bank resolution in a systemic crisis”, CEPS Commentary, 7 June 2012.

Commentary and VoxEU column,<sup>13</sup> it is important to distinguish what is needed to stop a ‘systemic’ confidence crisis hitting the banking system in certain countries – as I have discussed above – from the arrangements required at EU level to build a stable banking and financial system while preserving the internal market. For sure, extending a ‘blanket’ deposit insurance to all cross-border banks would not be easy to agree and would not work to restore confidence, given that it would entail new substantial liabilities falling on governments. It would also aggravate moral hazard.<sup>14</sup>

As to the banking union itself, the European Council cannot be expected to come up with a complete blueprint, but it should at least set clear goals and deadlines, as it managed to do twice in the last decade with the Financial Services Action Plan and the reform of the EU supervisory structure. The ingredients are known and must encompass centralisation of supervision (probably with the ECB, in view of its stronger credibility), the creation of an EU-wide deposit insurance scheme for cross-border banks, with attendant insurance fund (building on existing national arrangements, rather than substituting them with a brand new scheme), and a supranational crisis management and resolution procedure.<sup>15</sup> A central requirement is a new system of mandated supervisory action, closely linked to the new deposit insurance, whereby supervisors would be obliged to act – or at least be bound by a strong presumption to act – when bank capital weakens below certain thresholds. This is the only way to end supervisory forbearance and overcome the tendency for national supervisors to gang up with their regulated entities, to the detriment of depositors and taxpayers, but also eventually the internal market.<sup>16</sup>

<sup>13</sup> J. Carmassi, C. Di Noia and S. Micossi, “Banking Union in the Eurozone and the European Union”, CEPS Commentary, 12 June 2012.

<sup>14</sup> International Association of Deposit Insurers (2012), “Transition from a blanket guaranty or extended coverage to a limited coverage system”, Discussion Paper, Basel, February.

<sup>15</sup> See K. Lannoo, “Banking Union in Three Steps”, CEPS Commentary, 12 June 2012.

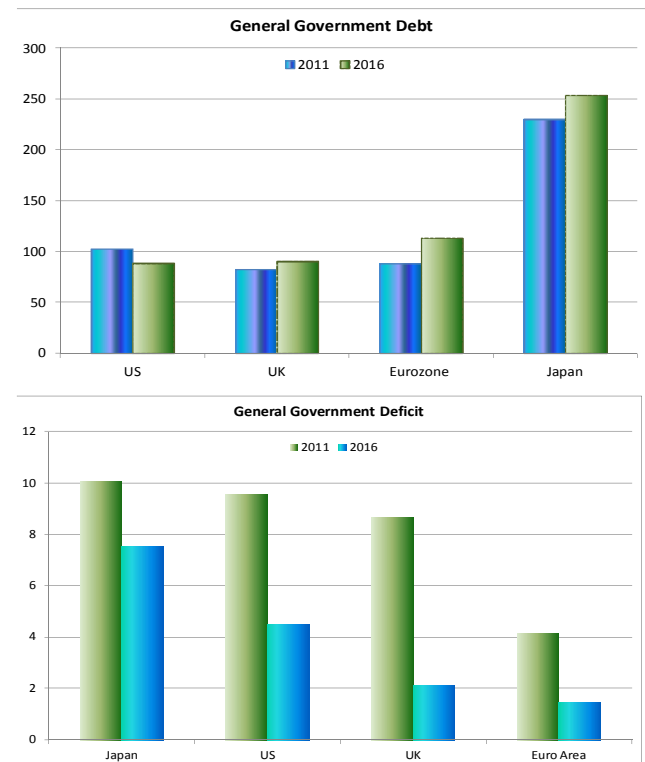
<sup>16</sup> J. Carmassi, E. Luchetti and S. Micossi, *Overcoming Too-Big-To-Fail – A regulatory framework to limit moral hazard and free riding in the financial sector*, CEPS Paperback, March 2010.

#### 4. Managing the debt overhang

Following the 2007-09 crisis, a rapid and large increase of government debt has been a generalised phenomenon in the industrially advanced world: for the first time, the average debt-to-GDP ratio for OECD countries has surpassed 100%; it is over 200% per cent in Japan and 120% in Italy, but many other countries, including the United States, have surpassed 100% and several yet are passing the 90% mark. Budgetary consolidation will weigh on growth prospects for two generations to come, and the welfare state as we have known it in Europe since World War II will have to be transformed, also in view of the rapidly aging population.<sup>17</sup>

While this situation is common to much of the advanced world, the eurozone debt crisis has features that set it apart: while the average debt-to-GDP ratio is no higher than that in other advanced countries, and consolidation efforts have started earlier resulting in a much lower deficit-to-GDP ratio (Figure 4), in the past two years the eurozone has been mired in a severe crisis of confidence.

Figure 4. General government debt and deficit, 2011 and 2016 (% of GDP)



Source: IMF WEO, April 2012.

<sup>17</sup> D. Sutherland, P. Hoeller and R. Merola (2012), “Fiscal consolidation: how much, How fast and by what means?”, OECD Economic Policy Papers, April.

As demonstrated by Professor De Grauwe, this points to a systemic dimension of the crisis that cannot be reduced to profligate behaviour by budgetary sinners but also has roots in flawed institutions of the monetary union itself.<sup>18</sup>

In synthesis, three main flaws have been made evident by developments since the Greek financial crisis started:

- (i) The system lacked effective safeguards against divergent budgetary policies. The Stability and Growth Pact could have offered a shield but it was fatally weakened when France and Germany suspended its application for themselves, in November 2003; at all events, as long as enforcement of budgetary discipline is entrusted to an intergovernmental body, the problem is bound to reappear, limiting the credibility of common budgetary rules.
- (ii) From the start until the aftermath of the post-Lehman financial crisis, the single monetary policy entailed low real interest rates in high-inflation countries and high real interest rates in low-inflation countries, encouraging excessive government deficits and credit growth to the private sector in the former countries and depressing investment in the latter, and financing economic divergences. As a result, 'core' countries' banks accumulated excessive claims on divergent countries in the periphery.
- (iii) Once the crisis hit, leading to a re-pricing of risks in financial markets, the disconnection between monetary (centralised) and fiscal (decentralised) powers has created a vacuum de facto impeding full use of monetary instruments to meet monetary and financial shocks, and leaving individual members of the eurozone exposed to brutal pressure by financial markets.

Over the past two years, fundamental changes in the economic governance have tried to rectify these flaws, alas so far without succeeding. An excessive burden for keeping the system afloat has fallen onto the ECB; disagreements on the interpretation of the crisis and its cures have opened a gulf of mistrust and recrimination between its members.

<sup>18</sup> P. De Grauwe, "The Governance of a Fragile Eurozone", CEPS Working Document No. 346, May 2011.

By now it is clear that there will be no lasting remedy to the crisis of confidence, unless all three problems are dealt with simultaneously. History indicates that a fully functioning monetary union requires a mutualisation of government debts and centralised taxation powers to back up the central bank in case of large financial shocks; an effective balance budget obligation and no-bail-out rule constraining 'sub-federal' levels of government; and a central bank free to act as required to confront liquidity and confidence shocks.<sup>19</sup> All this is not in the cards today and can only be achieved within the context of a full federal union, as Ms. Merkel is right to point out (and Mr. Hollande would be wise to heed, with full understanding of the implied surrender of sovereignty).

The question determining whether the eurozone will survive is whether, while setting explicitly for itself the ultimate goal of federal union – which so far has not happened – the European Council can put together intermediate arrangements capable of halting the crisis and restoring trust among its members, as a bridge towards the ultimate goal.

Of course, when push comes to shove, the ECB has little choice but to intervene as required to stop contagion and the melting down of sovereign and banking markets. It should be stressed that its statutes pose no limitation to its market interventions, with the sole proviso that they should not endanger price stability – which is not likely with the present dramatically high demand for liquidity. However, its task would be haphazard and exposed to enormous risks, were it not able to count on solid agreement between the member states on how to deal with the excessive build-up of sovereign debts.

Thus, the second building block of effective transitional arrangements that is coming together is made up by the new economic governance arrangements and the Fiscal Compact. Ratification and full bona-fide implementation of the latter is an essential component for rebuilding mutual trust within the eurozone, and therefore should be pursued as a matter of the highest priority and urgency.

The third, and final building block is some kind of mutualisation of sovereign debts. This is necessary

<sup>19</sup> M.D. Bordo, A. Markiewicz and L. Jonung, "A fiscal union for the euro: Some lessons from history", NBER WP No. 17380, September 2011.



for two reasons. The first reason is economic sustainability of adjustment: there is an urgent need to lower the spreads that the eurozone periphery must pay on its outstanding public debt, which risks frustrating ongoing efforts at budgetary consolidation and indeed pushing indebted countries beyond the point of dynamic instability. It should not be overlooked, in this regard, that – should Spain or Italy lose market access – the attendant costs for Germany would climb steeply both if it decided to rescue them or if the euro was let go and the eurozone broke up.

The second reason requiring some debt mutualisation is political sustainability: political support for painful and protracted adjustment programmes cannot survive without stronger signs that sacrifices will bear fruits – which cannot happen unless the sovereign risks are somewhat shared. Please note that I am talking of sharing risks, not directly the debt burdens.

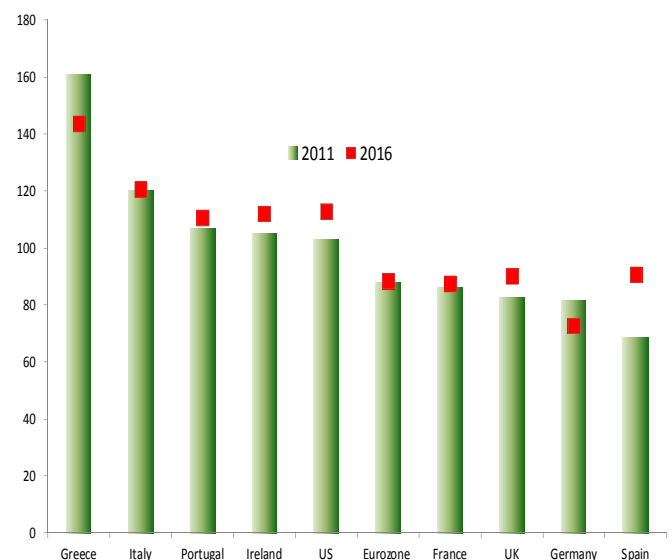
A cursory look at Figure 5 confirms that the issue of economic and political sustainability is a serious one. According to IMF estimates, under current growth and interest rate scenarios, by 2016 the debt-to-GDP ratios of most eurozone countries will basically not diminish or only do so marginally, and as a result the average debt-to-GDP ratio for the eurozone will actually increase. The main exception is Germany, where the ratio will decline below 80% – but nonetheless remain well above 60%. Some decline is also observed for Greece, but this is of course the result of debt restructuring.

This is the most difficult issue since German taxpayers must be convinced that they are not asked to make good the debts incurred by others. The good news is that a proposal that meets this requirement exists, namely the proposal for a debt redemption fund put forth by the German Council of Economic Experts.<sup>20</sup> The idea is fairly simple: all sovereign debt in excess of the 60% debt-to-GDP ratio of eurozone member states, excluding those already under financial assistance, would be

<sup>20</sup> German Council of Economic Experts, “Euro Area in crisis”, Annual Report 2011/12, Third Chapter, Wiesbaden, November 2011. See also P. Bofinger, L.P. Feld, W. Franz, C.M. Schmidt and B. Weder di Mauro, “A European Redemption Pact”, VoxEU, 9 November 2011; and H. Doluca, A. Hübner, D. Rumpf, B. Weigert, “The European redemption Pact: An Illustrative Guide”, German Council of Economic Experts, Working Paper 02/2012, February 2012.

placed in a redemption fund (over a transitional ‘roll in’ period of 3-4 years), in exchange for jointly guaranteed 25-year debentures issued by the fund in financial markets, with an immediate substantial interest rate relief for more indebted countries. Each country participating in the scheme would continue to service its own debt, pro-quota, until full redemption. To this end, it would have to segregate for the redemption payments a specific revenue source from its national budget, under appropriate irrevocable arrangements. After 25 years, all the debt would be paid out and all countries would have debt-to-GDP ratio at or below the 60% target.

Figure 5. Public debt in selected countries, 2011 and 2016 (% of GDP)



Source: IMF WEO, April 2012.

Table 3 throws some further light on the issue. The left-hand columns report current and structural primary balances – i.e. total expenditures minus revenues and interest payments – in 2011 of selected eurozone members, and in the centre column the primary balances implicit in budgetary targets agreed by each country under the excessive deficit procedure or broad policy guidelines (3<sup>rd</sup> column from the left). The table also report the longer-term estimates prepared by the OECD of primary balances required to bring the debt-to-GDP ratio to 50% by 2050 (4<sup>th</sup> column). The latter estimate is interesting since it incorporates long-term pressures deriving from pensions, health and long-term care. As may be seen, on this score, Italy looks better than France, Germany and the Netherlands, mainly thanks to its pension reform.

Table 3. Budgetary consolidation requirements (% of GDP)

	Primary balance in 2011*		Primary balance required		
	actual	structural	to meet agreed budgetary target (change 2011-2015*)	to stabilize the current debt ratio by 2050 (OECD**)	under the ERP***
Germany	1,6	1,8	0,9	4,8	2,0
France	-2,6	-1,6	4,3	5,4	2,4
Italy	1,0	1,3	4,7	2,6	4,2
Spain	-6,1	-4,9	8,1	4,2	2,5
Netherlands	-2,6	-1,4	1,6	6,3	1,5
Belgium	-0,4	-0,1	3,8	6,0	2,9
Ireland	-9,7	-4,9	12,5	8,6	-
Portugal	-0,4	-6,2	4,1	3,0	-
Greece	-2,4	-	6,9	3,3	-

\* Source: European Commission, "Assessment of the 2012 national reform programme and stability programme" for Member States, 30 May 2012. For Greece, European Commission, "The Second Economic Adjustment Programme for Greece", March 2012.

\*\* Increase in the underlying primary balance needed to bring gross financial liabilities to 50% of GDP in 2050. Source: OECD, "Fiscal Consolidation: how much, how fast and by what means", OECD Economic Policy Paper No. 1/2012, April.

\*\*\* Source: German Council of Economic Experts, "The European Redemption Pact: An Illustrative Guide", Working Paper No. 2, 2012.

The table highlights that indeed strenuous efforts will be required over decades to maintain acceptable budgetary balances. The last column reports the primary balances that would be required, under appropriate assumptions on interest rates, under the European Redemption Pact (ERP) of the German Economic Experts: the savings are substantial, and may indeed make the whole difference between (economic and political) sustainability and un-sustainability. The Table confirms that the effort required of Greece, Spain and Ireland may not be realistically achievable, pointing to the need of relaxing existing commitments.

Under the ERP, Germany would shoulder some of the risks of sovereign debt in the periphery – and pay an interest premium for this – but would be fairly secure that it will not have to repay debt incurred by others. The redemption fund would be a temporary device. Capital markets would in all likelihood very much like the debentures issued by the fund, leading to the creation of a liquid and deep market for eurozone paper. Over time, with progress towards federal union, these securities could be substituted by jointly issued Union bonds of the federation – without any need for anyone to take over the accumulated obligations of others.

## 5. Conclusions

As all too often in the recent past, the European Council meets in a make-or-break environment, with Greece barely back to the operating table and Spain and Italy still under heavy pressure in financial markets. These pressures will not go away until the heads of state and government show some solid consensus on policy framework capable of reconciling austerity with growth, dealing with the debt overhang, and ensuring that the ECB can provide adequate liquidity support without endangering its balance sheet and independence.

This note has outlined the main ingredients of such a package that is not impossible for the eurozone members to consider and yet holds good promise to go a long way towards restoring confidence and normal conditions in financial markets.



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