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# Confronting the Crisis

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The euro crisis has not gone away on holiday. In fact, it continues to generate a never-ending string of horrific headlines. Where is it all going to end? In this article we describe the proposed remedies that are currently being discussed, and what blue and red eurobonds, euro bills, FIRE and the debt redemption fund can actually achieve.



## I

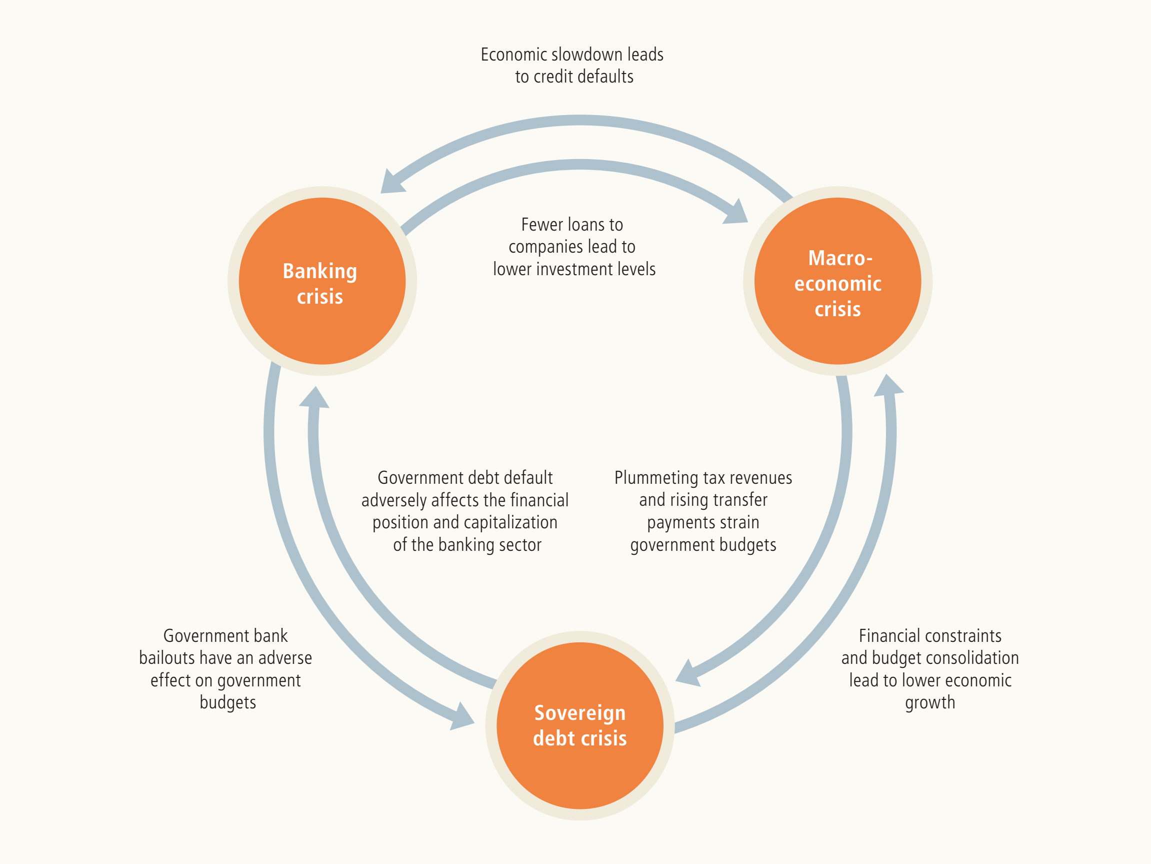
Dark clouds are once again piling up over Greece. Its reform process is moving ahead at a very sluggish pace, and there has been another bout of speculation about an imminent “Grexit.” Furthermore, the situation in Spain has taken a turn for the worse. At the end of June Spain was granted loans amounting to €100 billion in order to enable it to prop up its ailing banks, but this has not been enough to defuse the situation. It is becoming increasingly clear that, in spite of its austerity and reform programmes, Italy will not be able to weather the crisis on its own. A safety net amounting to €700 billion is not going to be enough for the EU’s third-largest economy. And in any case, it has not as yet come into force. The fact of the matter is that the eurozone is waiting for a ruling by Germany’s Federal Constitutional Court, which has until the middle of September to decide whether or not the ESM is in compliance with the Basic Law.

The financial markets have reacted in a nervous and at times panic-stricken manner. Investors are withdrawing increasingly large amounts of capital from the crisis-ridden countries. Stock prices are plummeting. And recently the euro hit a new 2-year low against the dollar.

One might be forgiven for thinking that so far the politicians and their attempts at crisis management have simply accelerated the downward spiral. At any rate, the trust of the financial markets has not yet been regained, at least not in the long term. After umpteen euro crisis summits the heads of state and government have not come up with a way of breaking

## A Vicious Circle

The banking, sovereign debt and macroeconomic crises create a vicious circle




Source: German Council of Economic Experts



out of the vicious circle of sovereign debt crisis, banking crisis and economic crisis. And one is inclined to agree with the economists who from the very beginning were in favour of the "big bazooka" or "Big Bertha". They believe that the European Central Bank (ECB) should be allowed to follow the example of the US Federal Reserve (FED) and have the right to keep printing money for as long as it wants. As a result doubts about the solvency of eurozone states and their banks would be nipped in the bud.

Similar ideas were behind demands to communitarize sovereign debt in the eurozone and to issue joint government bonds (or eurobonds) for refinancing purposes. Joint and several liability for credit defaults is intended to be a firewall which will prevent financial market speculation against individual eurozone states and to bring down interest rates to an acceptable level.

## II

## Not all bonds are the same

So far the German government in particular has flatly rejected the communitarization of debt. In the public debate on the subject "eurobonds" and terms such as "debt union" or "transfer union" have become political battle cries, and they have created a veritable minefield. All this obscures the fact that a number of very different models have now been developed, and they are not concerned to organize joint and several liability for all and sundry, but to remove the pressure exerted by the financial markets on the countries suffering from a debt burden. These countries obviously need both the will and the time to introduce budget consolidation and structural reforms.

The most important types of eurobond are described below. In essence they differ in two ways, that is:

1. The extent to which national bonds are going to be replaced by European bonds; and

2. The guarantees which will be given for these bonds, i.e. whether the member states will assume joint and several liability for the new joint sovereign debt, or only partial liability, as in the case of the ESM.

They also differ with regard to the speed with which they can be deployed to combat the crisis. Joint and several liability has hitherto come up against the no bail-out clause enshrined in the European treaties (Art. 125 TFEU). In order to enable EU countries to assume such liability, the EU would have to amend the Treaty of Lisbon with the help of the ordinary revision procedure. This would also apply to any attempt to enlarge the mandate of the ECB. With the best will in the world such a procedure, which includes a Convention, an intergovernmental conference and the ensuing ratification process in all 27 member states, would take at least five years.

## One for all, all for one

Stability bonds: The idea of creating a common market for bonds in Europe on the model of the US and the Treasury Bonds was already being talked about long before the outbreak of the euro crisis. The advantages of a large bond market of this kind, so the thinking goes, are the economies of scale that can be achieved, and the lower refinancing costs. Furthermore, the size of the market can also afford better protection against external shocks and the herd behaviour of many investors, which in the final analysis has done so much to exacerbate the current crisis. And advocates of a common bond market believe that it will increase the likelihood that the euro will become a genuine global reserve currency, and that this in turn will be beneficial in all sorts of ways.

With such eurobonds all the debts of the economically weak and economically strong eurozone countries would be put into one basket, and liability for the debt would be assumed jointly and for an indefinite period. Pooling credit risks, so the thinking goes, will be of benefit to the weaker member states because they will have to pay lower interest rates. On the other hand, stronger states will have to pay higher interest rates and shoulder greater risks. However, data issued by the European Commission, which were presented in November 2011 in its “Green Paper on the feasibility of introducing stability notes,” have put a damper on overly optimistic expectations. It suggests that the yield gain of between 10 and 20 basis points from a higher issuance volume is fairly limited. The Commission believes there are situations in which it cannot be ruled out that interest rates in what are now low-yield states such as Germany, the Netherlands and Finland will rise “in the absence of any improvement in the credit risk of the current high-yield issuers.”

In legal terms the communitarization of sovereign debt in the eurozone is dependent on the advent of a political union in which the responsibility for fiscal and economic policy has been conferred on the EU and is thus no longer in the hands of the member states. This is the only way in which budgetary discipline and reforms can be implemented and enforced. Even if we assume that the political will exists, such a step cannot be taken without making far-reaching amendments to the treaty. They would also make it necessary to place the democratic legitimacy of the EU on a completely new footing. This model is of little or no use in the current crisis.

## Paying above 60 percent

Blue & Red Bonds. Jacques Delpla and Jakob von Weizsäcker of the Brussels think tank Bruegel were among the first to unveil a scheme for the introduction of eurobonds after the outbreak of the euro crisis. In view of the inherent systemic risks they came to the conclusion as early as the beginning of 2010 that the liability disclaimer for the debts of other eurozone countries was no longer tenable. In fact they predicted that the Greek liquidity crisis would affect the banking sector and mushroom into a European banking crisis with unpredictable consequences for the European economy.

However, they were of the opinion that the sovereign debt of the eurozone should not be completely communitarized, and that only debts amounting to 60% of GDP should be included. That is the margin which was stipulated in the Treaty of Maastricht as a state's total debt ceiling. These government bonds, or blue bonds, as they are called, will have priority status. Since they relate to the first (and what one might call "healthy") 60% of a state's sovereign debt, the authors expect that blue bonds will have an AAA rating and low interest rates.

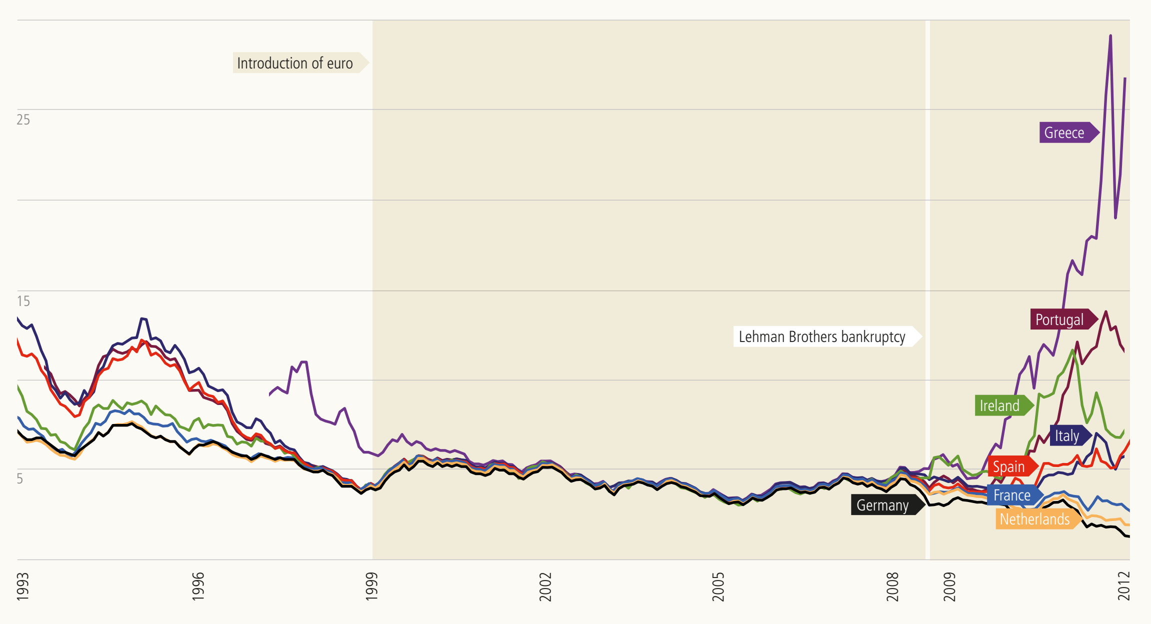
Any debt over and above this limit will continue to be national debt for which other member states will not assume liability. In order to ensure that the banking sector is not affected if the state becomes insolvent, and that in future a sovereign debt crisis and a banking crisis cannot reinforce each other and make matters even worse, the national bonds (or red bonds) are to be kept out of the banking system.

The allocation of blue bonds will be dealt with on an annual basis by an independent stability council. The national parliaments will then vote on whether or not to accept its proposals. If a country does not give its assent to the proposals, it will not receive any blue bonds in the year in question, nor will it assume liability for the new bond issues. Thus the blue bond issues stand and fall with the willingness of the more stable countries to shoulder the burden of more risk and liability. The authors have no more than a rather rough idea of how low or how high the yield risk will turn out to be for blue and red bonds. But a country such as Italy, which has a total debt amounting to more than 130% of GDP, would benefit only if the lower yields of the blue bonds compensated for the higher yields of the red bonds.

On account of the volume of the debt involved, which amounts to up to 60% of the sovereign debt of the eurozone, these eurobonds could not be introduced without amending the Treaty of Lisbon.

## European government bond yields come under pressure

Interest rates on government bonds in percentage points, January 1993 to June 2012




Source: OECD

## Paying below 60 percent

Debt redemption fund: This proposal applies only to countries which have not as yet availed themselves of any kind of financial assistance, and is based on three pillars: a debt repayment fund designed to facilitate the temporary and limited communitarization of debts; the fiscal pact; and an insolvency procedure for states. Sovereign debt which exceeds the 60% limit stipulated in the Treaty of Maastricht will be shifted to the debt repayment fund. The aim is to repay it over a period of about 25 years. Every country will remain responsible for the debt it has outsourced, and will repay it on its own. Collective liability will only come into play if a country becomes insolvent. Debt will not be outsourced in one fell swoop, but over a number of years. In this transitional period, the so-called roll-in phase, the fund will gradually be able to meet the refinancing requirements.

After this phase has come to an end, the debt that has not been outsourced should be on the level of the 60% limit stipulated in the Treaty of Maastricht. States will be refinanced by purchasing one-year to two-year bonds on the primary markets. The preconditions for access to the repayment fund are the ratification of the fiscal pact, which requires the member states to incorporate a debt brake in their constitutions, and adherence to strict conditionality (on the lines of the conditions attached to the EFSF/ESM). Among the proposed disciplinary measures is the suggestion that a country should lose part of its access to lower interest rates if it is not in compliance with the requirements. Furthermore, every country will impose new taxes and use the revenues exclusively for debt reduction purposes. And on top of this the debt redemption fund will be collateralized by 20% of the states' assets, e.g. their foreign currency and gold reserves.

The authors are confident that they can insert the debt repayment pact into the existing legal framework, and cite Article 136 paragraph 3 of the Treaty on the Functioning of the European Union (TFEU), which states that voluntary assistance measures to safeguard the stability of the euro are permissible if they are "indispensable" and "made subject to strict conditionality."

## Ten percent for more liquidity

Euro bills are joint bonds with a one-year maturity which have senior debt repayment status. They are based on joint and several liability. That is why euro bills are especially safe bonds. At the same time this would create an extremely liquid segment of the bond market that banks, which are being compelled to increase their capital reserves as a result of the Basle III rules, will find especially attractive. Furthermore, it would prevent capital flight from the bonds of the weaker eurozone states into bonds of the stronger eurozone countries.

These short-term bonds would be issued by an independent institution which the authors, Christian Hellwig and Thomas Philippon, call "Joint Debt Management Office." This debt agency would have the sole right to issue euro bills, and would determine quotas on the basis of what the member states required. National governments would be forbidden to refinance themselves on the side by issuing short-term national bonds.

Euro bills will be available only to states which have invested less than 10% of their GDP in such short-term bonds. A further precondition for participation in euro bill auctions is that the states must be in compliance with the requirements of the Stability Pact plus, the six-pack and the European semester, the mechanisms and agreements with which the member states have entered into a commitment to adhere to budgetary discipline and structural reforms.

According to their inventors, euro bills can be introduced without amending the Treaty of Lisbon. The reason for this is the fact that the liabilities which will have to be borne by the stronger states are manageable, and will exist only for a limited period of time.

Thus euro bills are a way of buying time in which to launch financial reforms and to regain the confidence of the markets. However, if things have already reached crisis proportions, and there is a stark choice between joint destruction or joint salvation, then euro bills may not be of much use.

## Redistributing crisis profits

FIRE: Friedrich Heinemann of the Centre of European Economic Research (ZEW) recently presented a rival scheme entitled fiscal interest rate equalization (FIRE). This is designed to defuse the crisis of confidence on the bond markets and the associated refinancing burdens, especially in the case of Spain and Italy, by means of a compromise with regard to interest rates. The fact is that more and more investors are reacting to the crisis by withdrawing capital from countries beset with financial problems and investing it in states which still have a high creditworthiness rating.

The latter, including Germany and the Netherlands, hardly have to pay any interest at all or are actually paid for borrowing money. So the idea is that these low-yield countries should put some of their savings into a special fund. And this fund would help states which the markets have punished by demanding higher interest rates. However, the scheme is not trying to achieve total equalization, since this would deprive the market of its disciplinary pricing power.

Thus equalization will only apply to interest rates above 5%. The ZEW has estimated that in 2012 the fund would need about €6 billion for Italy and Spain. And only states where interest rates are lower than 2.5% would contribute to the fund. Thus Germany with its 90% share would in so many words have to finance most of the interest rate equalization scheme. This is a significant amount of money, but far less than the costs which would have to be met if both countries had to seek protection under the EFSF/ESM. It is a fact that the guaranteed lending capacity of the EFSF/ESM is barely sufficient for Spain, and is certainly not large enough for Italy. There is a clear need for additional funding. To date Germany has made a commitment to contribute slightly less than €170 billion. And this does not include the guarantees for Greece.

This kind of interest rate equalization would to all intents and purposes resemble the repeated ECB purchases on the secondary market throughout the crisis of government bonds issued by states which have come under pressure. For the foreseeable future and in the absence of an appropriate new governance architecture, which will probably materialize and make it possible to introduce eurobonds only after the Treaty of Lisbon has been amended, this equalization mechanism will be able to provide assistance within a short space of time. It homes in on one of the main problems of the current crisis, and in the stricken countries will reduce the cost of debt refinancing. As in the case of euro bills, the beneficial effect of this interest equalization mechanism would become less apparent whenever the crisis took a turn for the worse, or drove up the costs for Germany to a level where it would once again become necessary to think about the introduction of eurobonds or a new mandate for the ECB.

**III**

## Stability has its price

A great deal of thought needs to be given to the whole question of whether or not and indeed of how eurobonds and their two smaller sisters, euro bills and FIRE, can break out of the vicious circle. Everything that has happened in the crisis hitherto points to the fact that at the end of the day the solution will be a new role for the ECB as a “lender of last resort” on the lines of the FED.

At any rate, after all that we now know, it will be impossible to take the sting out of the euro crisis and prevent the contagion from spreading to other states if the powers that be continue to reject joint and several liability out of hand. Rescue measures of a more comprehensive kind than those which currently exist in the shape of EFSF/ESM seem unavoidable.

It would be a good idea, and not only from a German point of view, to turn the eurozone into an economic and stability union before proceeding to assume liability for the debts of other member states, especially after the negative experience of the Stability and Growth Pact. However, it may now be too late to put governance before liability.

The stronger eurozone countries would be well advised to think more deeply than they have done in the past about whether or not it is in their interests to prevent the eurozone from falling apart. Hitherto Germany has benefited from the euro. Thus it has every reason to subscribe to what the German Council of Economic Experts had to say in their annual report for 2011/12: "Anyone wishing to reap the benefits of open goods markets must be prepared to face up to the instabilities and shocks of globally networked money and capital markets and make provisions in the one or other way to protect the domestic exporting economy from manifest damage. Historical experience shows that as a rule this does not come without a price."

The EU can quite obviously exist without the euro. Two member states, the United Kingdom and Denmark, have stated that they do not intend to adopt it. However, it would no longer be the EU which, in the Preamble to the Treaty of Lisbon, proclaimed that it was in "the process of creating an ever closer union among the peoples of Europe." Nor would it be the EU in which the ongoing evolution of a genuine political union is creating the European opportunities of the future in a globalized world. ■

## Further Reading:

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