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Ways Out of the European Sovereign Debt Crisis after the Decisions of the July 2011 Summit

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The current sovereign debt and balance of payments crisis of some European countries, contrary to many public impressions, is not a 'child of the Monetary Union'. There have been similar crises in Europe, most recently the 1992/93 crisis of the former European Monetary System (EMS), which also imposed significant financial and economic burdens on Germany.[1] Past crises, however, had an impact primarily on the exchange rates; in the Monetary Union with its fixed exchange rates, the crisis affects interest rates and interest rate spreads on government bonds. Regardless of these different symptoms, however, the root causes of these crises are very similar: it was and is basically a *crisis of confidence* – confidence in the fiscal-policy competence of a country, and ultimately its *competitiveness*. Because only a regained competitiveness can lay the foundation for a recovery of government finances and the private financing of the current account deficit, which currently in the case in Greece and other peripheral states is being publicly financed *via* the refinancing facilities of the banks of these countries in the Eurosystem and which is reflected in the so-called Target2 balances. These balances are accordingly not the 'fire' but the 'smoke', not the cause but a consequence of deep-seated imbalances.

The 'classic way' to restore competitiveness in a system of flexible or at least variable exchange rates is currency devaluation. Accordingly, this path is often proposed as a solution for the current sovereign debt crisis in Greece, resulting in Greece being excluded from, or more politely put, leaving the monetary union. Regardless of the legal and political implications of such a move, and in particular the risk of a negative impact on the European unification process in the form of increasing disintegration and political strife, as observed also in previous currency crises, in a regime of flexible exchange rates with a currency depreciation we would ultimately only be 'buying time'; a devaluation would not resolve the deeper-seated problem of the competitiveness of a country – the investment environment, labour-market regulations, efficiency of the civil service and the administrative infrastructure, ultimately the 'business model' of a country. There is even a risk that with the price reduction effect of a devaluation, fundamental problems will be seen as less urgent and their solution will be postponed and that devaluations will lead, *via* import prices, to spurts of inflation (price-wage spirals) that have a harmful effect on growth.

When fixed exchange rates are in effect, i.e. in a monetary union, the adjustment process proceeds, as many pointed out before the monetary union was created, *via* the 'real exchange rates', i.e. *via* an adjustment of the total wage and price structure and the other factors on which the competitiveness of a country depends. This reform path *via* the 'fundamentals' is certainly more painful than an adjustment of the nominal exchange rate (which leaves the internal price relationships initially unchanged), but it addresses the structural roots of a currency or balance of payments crisis and therefore offers the chance of a sustainable solution.

The treaties of the European Union in principal offer the advantage of being able to develop and deploy an *institutional framework* that triggers and ensures the required deep structural reform measures as well as structural reforms that must occur in addition to the necessary adjustment of wages and prices (in the case of Greece, sweeping reforms of the administrative infrastructure, privatisation and the efficiency of public services). This institutional framework, that needs to be developed further, was damaged by the

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[1] This also includes the increase in the money supply in Germany as a result of the monetary-policy assistance but also the interest-rate increases in Germany that were necessary in terms of stability policy but that went beyond what was necessary in terms of the domestic economy.

2004/2005 decision to weaken the Stability and Growth Pact, a historic mistake that was labelled a 'reform' at the time. With a functioning Stability Pact, the Greek deficit in 2009 would not have been the 3.6 percent reported to the EU Commission that then turned out to be 15.4 percent, which ultimately was the trigger for the crisis of confidence and rising spreads on government bonds. With the '*ex ante* safeguarding' of the Stability Pact having been decisively weakened in 2005, the heads of state and government decided in 2010 to implement the temporary solution of EFSF (European Financial Stability Facility) and from 2013 the permanent solution of ESM (European Stability Mechanism), an '*ex post* adjustment mechanism' that is based on two major C's (credit + conditions). These legal pillars of the new institutional framework will only be successful, however, if they are supported by concomitant economic incentive mechanisms.

Following the decisions of the Summit of 21 July 2011, a sense of relief was felt not only politically but also in the markets, which was noticeable in the declining spreads on Greek government bonds. After a prolonged period of uncertainty, which was fuelled almost every day by new debt restructuring models (and for which the solution was often proposed without the most important partners, namely the central banks of the Eurosystem that are responsible for the inclusion of Greece in the European money market), the summit decisions demonstrated the ability of the eurozone to take action and averted at least for the immediate future the danger of negative political dynamics in the euro area. After the experience with the decisions of May 2010, however, there are doubts as to whether the positive market reaction will last.

The positive aspects of the Summit decisions, in addition to avoiding a (further) mixing of central bank functions and fiscal policy, are above all the avoidance of false solutions such as the introduction of new taxes, the prevention of (explicit) Eurobonds and thus a communitarisation of debt without a simultaneous communitarisation of spending decisions (i.e. a political union),[2] as well as the promise to strengthen the Stability and Growth Pact and the further involvement of the IMF in the volume and control of the programmes.

The agreement in principle on an additional credit and structural adjustment programme for Greece with the impressive volume of an additional 109 billion euros is realistically the only way to achieve a broad-based improvement in the competitiveness of the country and to influence decisions regarding a greater efficiency of the public sector, a reform of the administrative infrastructure, a sweeping privatisation, a reduction of bureaucracy and an improvement of the investment environment, and not least finding a way to curb widespread corruption. In contrast to no longer reversible one-off measures such as debt cancellation, debt assumption or debt guarantees, the method of a gradual issuing of credit (in tranches) will permit a continuous and credible monitoring of progress on reforms.

The decision to involve the private sector, which policy-makers underscored so much, is ambivalent, in my opinion, since this was bought at the price of considerable public securities *vis-à-vis* the investors (and thus was more of a 'bail-out' than a 'bail-in'); but still, the foreseeable negative side effects of a strict restructuring were limited through the avoidance of a 'credit event' for the credit default swaps (CDS) as well as a recapitalisation assurance for the Greek banking system. Also the key requirement for confidence in the European monetary policy of 'adequate security' (Article 18 ESCB Statute) by means of the pledges (which still need to be concretised) of additional collateral for Greek bonds was largely respected.

The *longer-term assessment* of the decisions and their impact on public confidence in the markets, however, depends largely on the extent to which the newly designed *institutional framework* creates the right incentives. As experience shows, well-intentioned regulations and monitoring process are mostly in vain if false incentives within the institutional framework lead to a weakening of the specifications and requirements.

In this connection, the policy decisions – the details of which are still open – on *secondary market purchases* by the European funds EFSF and ESM give cause for concern as well as the granting of a 'precautionary principle' of the European funds. Also the (further) reduction in interest rates for the programme loans to come 'close to the financing costs of EFSF' (Section III of the Summit Declaration of 21 July 2011) are not aimed at increasing pressure in the direction of a country's own capital market viability and repayment of the European credits by the peripheral states.

[2] Such a political union would also have to include decision-making processes that are fully in accord with democratic principles, including a largely equal weighting of votes for elections to the European Parliament and European MPs elected directly in the voting districts.

Purchases on the secondary market also entail the temptation to battle the 'smoke' (higher interest rates) instead of the fire and the fire sources (inefficiencies of fiscal and economic policy). And unlike purchases in the primary market, which is equivalent to the granting of a loan, it is also difficult to connect secondary market purchases with the criterion of conditionality.

The link with due conditionality is also the main problem of the planned precautionary credit line, since the flexible credit line (FCL) of the IMF, which is used as a model, is only based on a general assessment of the financial soundness of a country and not on actual conditions. But a strict conditionality of aid is also anchored in Article 136(3) TFEU, which is to be the legal basis of the future ESM as of 2013. The (few) content specifications of the planned addition of the institutional framework must not be eroded before they even take effect.

In the detailed working out of the decisions, which will take place under the Polish Council presidency, the principle of *individual fiscal responsibility* of each member state of the monetary union should be given the greatest possible weight and in particular the principles of *conditionality* and *market discipline* should be consistently implemented. This could, for example, consist of embedding the 'precautionary credit line' in a similarly 'precautionary', but binding adjustment programme and to concentrate secondary market purchases on an offer to the Eurosystem to take over the accumulated government bonds (SMP). In terms of the agreed interest rate cuts for the programme loans, it should at least be assured that the mistakes are not repeated that were made in the phase of interest rate convergence of the monetary union after 1998; i.e. the relief effect of low interest rates should be used to the full to reduce budget deficits and not be used for other objectives.

The ultimate litmus test for the credibility of the decisions is likely to be the promised strengthening of the *Stability and Growth Pact*. Key elements here are the experience of the past, the introduction of a reverse majority and not only in the 'preventive part' but especially in the corrective part of the pact, in other words in the determination of an increased deficit and the start of an 'excessive deficit procedure' (EDP). Also necessary are credible sanctions, including the retention of European funds 'at source' and the suspension of a country's voting rights in fiscal and budget-related decisions of the European bodies. Also the possibility of 'procedural loops' that were introduced during the weakening of the Pact in 2005 and largely neglected by the public, i.e., the endless repetition of the 'prelude to sanctioning' (such as recommendations and their publication) should be eliminated to the benefit of a credible escalation mechanism.

The important goal of preventing contagion to other countries of the currency area can be best achieved – as with the medical risk of infection – by the *immunisation* of those who are likely to become infected. In terms of the sovereign debt crisis and the balance of payments crisis, this means concretely implementing fiscal responsibility as an incentive to increase competitiveness and thereby the confidence in the respective countries. This includes clear *ex ante*-rules of an 'orderly insolvency' of a member state of the EMU in case this state is definitely not capable or not willing to come along with the necessary adjustment. These rules should not only address the problem of recapitalization of banks but also how an insolvent state can get access to the money market (after the default of a state the ECB/Eurosystem can no longer accept government bonds as collateral – see Article 18 ESCB-statue). The media often refers to the insistence on this point of fiscal responsibility as a 'lack of solidarity' of the core European countries, especially Germany and other European countries. True solidarity, however, is reflected in sustainability, in the creation of a long-term stable basis for the monetary union. Solidarity presupposes solidity.