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Ansgar Belke

Reinforcing EU Governance in Times of Crisis: The Commission Proposals and Beyond

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Ansgar Belke[1]

Reinforcing EU Governance in Times of Crisis: The Commission Proposals and Beyond

Abstract

The recent extensive package introduced by the Commission is the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the Economic and Monetary Union. Broader and enhanced surveillance of fiscal policies, but also macroeconomic policies and structural reforms are sought in the light of the shortcomings of the existing legislation. New enforcement mechanisms are foreseen for non-compliant Member States. In this very crucial and important package of 6 legislative dossiers this paper tries to identify critical missing or redundant and/or unworkable elements within the Commission package. Moreover, it checks what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable as, for instance, crisis resolution mechanisms and debt restructuring, EMF, project bonds and Eurobonds.

JEL Classification: E61, E62, F55, P48

Keywords: EU governance; European Council; European Financial Stability Facility; European Monetary Fund; policy coordination; scoreboard, Stability and Growth Pact

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1 University of Duisburg-Essen, DIW Berlin and IZA Bonn. – Briefing paper prepared for presentation at the Committee on Economic and Monetary Affairs of the European Parliament for the quarterly dialogue with the President of the European Central Bank, Brussels, November 30, 2010. – All correspondence to Ansgar Belke, University of Duisburg-Essen, Department of Economics, 45177 Essen, Germany, E-Mail: ansgar.belke@uni-due.de.

1. Introduction

The extensive package introduced by the Commission is the "*most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the Economic and Monetary Union. Broader and enhanced surveillance of fiscal policies, but also macroeconomic policies and structural reforms is sought in the light of the shortcomings of the existing legislation. New enforcement mechanisms are foreseen for non-compliant Member States.*"

In this very crucial and important package of 6 legislative dossiers this briefing paper tries to:

- on the one hand, help to identify critical missing, or redundant/unworkable, elements within the Commission package, and,

- on the other hand, check what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable (e.g. crisis resolution mechanisms and debt restructuring, EMF, project bonds, Eurobonds etc.).

2. Clear change in perspective after European Council meeting

The package deal following Deauville

At the European Council meeting of 28-29 October, the heads of state came up with a quite striking package deal which was prepared a couple of days before at the bilateral French-German summit in Deauville. It changed the context of the legislative proposals on EU economic governance of 29 September 2010 decisively: the result was an unanimous agreement to conduct a 'limited' Treaty reform, which in turn puts Germany in a position to agree to a permanent crisis resolution mechanism, i.e. a permanent successor to the temporary three-year European Financial Stability Facility (EFSF).

Especially German politicians do not grow tired of announcing that the planned crisis resolution mechanism which will in the future call on private creditors for the financial recovery of ailing euro area member states will be implemented not earlier than 2013, the date by which any limited treaty changes can be ratified. But provisions are said to have been made in May 2010 *against every possible development in the years until 2013*. The responsibility of filing a petition to help rests upon each member state if a country should believe it is in need of this support. This briefing paper will later on argue that the notion of "every possible … " is not generally applicable in this context because the billions of euros ascribed to the EFSF package are gross values which might be enough to cope with a default of Greece and Portugal, but certainly not if Spain would also be involved.

France agreed to the proposal for a so-called permanent crisis resolution mechanism in exchange for Germany yielding to France's desire for *more lenient rules for states that break the EU's debt and deficit limits* (Belke, 2010b).

"Just adding a few words"

The agreement included a commitment not to change the so-called no bail-out clause (Art. 125 TFEU), but simply the already now proverbial "*addition of a few words*" to one or at a maximum two articles in the Treaty, among them Art. 122 TFEU. Just adding a reference to financial stability in Art. 122 was obviously assessed to be sufficient to satisfy the German Constitutional Court. At the same time it was intended to serve as a solid legal basis for the new permanent crisis solution mechanism which might amount to a permanent EFSF and will not necessarily explicitly appear in the wording of any Treaty change explicitly. The reason is that the "permanent EFSF" as a new EU institution falls outside Part 3 of the TFEU, and therefore cannot be created according to the simplified revision procedure (Gros, ó Broin and Kaczyński, 2010). The perspective of an only small Treaty change which allows for the use of the simplified treaty revision procedure and avoids the need for a referendum, let all 27 members agree. Another driving force was the insight that no crisis solution or insurance mechanism would be realistic which is not supported by the two largest (donor) euro area countries (Belke, 2010b, Gros, ó Broin and Kaczyński, 2010, Haede, 2010).

The summit meeting also came up with the conclusion that the IMF would play a role in the new mechanism, but did not make its role more concrete (Belke, 2010b). This probably implies that the new mechanism will be accessible only to governments which have complied with IMF conditionality as it was the case with respect to the recent rescue package for Greece.

Seen on the whole, the situation *does not seem to be under control* up to now. Sovereign bond spreads are flickering these days to heights not seen during the last months. On November 12, 2010, spreads in Portugal were close to 500bp per cent. In Spain, spreads were approaching the 230bp level at the height of the Spanish crisis in the summer, and the Belgian spreads have reached 100bp for the first time. Italian spreads also went up, though pressure has lowered a little bit in Ireland – but this is probably due to some support from the ECB. The explanation for these lingering doubts is quite simple: the problems that underlie the crisis (the precarious state of Greek public finances and that of the Spanish real estate sector) have not been solved.

It cannot be excluded that – within the next weeks - politicians will be forced to go for quick shots. The main danger is that there is *no fallback position* if countries beyond Ireland have to be rescued. Up to now there is a *legal vacuum* how to organize orderly and unscheduled default *in the euro area* (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries). The EFSF framework was meant to but would not cover the worst case in which Greece, Portugal, Spain and Ireland would all become needy. However, in reality the true liability limit of the EFSF framework would not be able to cover the case of, for instance, Spain, if the smaller countries would have become needy as well. The reason is that significant sums have to be deducted from the EFSF's total volume of 440 billion euro beforehand for general stabilization measures and maybe also - and this is often forgotten – utilized for guaranteeing some donors' claims.

Large-scale problems of the status quo

The scale of the current debt problem is large. For Greece, 110 billion euro have already been agreed upon. The EFSF plus EFSM headline amounts to a nominal value of 500 billion euro, which in reality corresponds to a sum of 255 billion euros, due to a couple of deductions. Most importantly, only those countries can act as guarantors for other states if they have a triple-A rating, i.e. the highest credit rating: Germany, France, the Netherlands, Austria, Finland and Luxembourg.[1] If the needs of Ireland and Portugal are considered to be of the same magnitude as Greece, this directly implies that the package might not be able to deal with Spain. If Portugal and Ireland turn to the EFSF then only the ECB can prevent financial market meltdown.

The first basic problem addresses the fact that the euro area is a monetary union, but not a fiscal or even political union. This is precisely why there is no guarantee clause (note that we later on argue that Art. 125 TFEU is not a 'no bail out' clause). "No bail out" is not credible with integrated financial markets. When markets are close to meltdown creditors have little choice.

Deciding on the way of "bailing in" the private sector is the second fundamental problem. The European Council was faced on October 29 with the pioneering question whether it should agree on a permanent 'crisis resolution mechanism' demanded by markets and debtor countries in exchange of a 'bail in' mechanism as demanded by Germany. The existence of the turning point per se and its actual solution have initiated huge turmoil in the markets.

[1] Correspondingly, the IMF would provide net credits at the amount of only 160 billion euro. In sum, analysts estimate that, hence, a total of 475 billion euro could be paid out as financial support.

Hence, details of the envisaged involvement of the private sector should be resolved quickly. Should it take place always? Should one re-design the timetable of repayments without altering the present value of the former (rescheduling) or even diminish the present value down to a level which appears to be sufficient to arrive at sustainable public finances (restructuring)? What about haircuts? Should they only be applied to new debt or should old debt also be considered?

Otherwise we might see tensions rising between the "North" and the "South" of the euro area. On the one hand, there is the view of the German Chancellor Mrs. Merkel who interprets Art. 125 TFEU as a "no bail out clause" and argues accordingly that the monetary union cannot become a transfer union. Hence, the "North" sees a member state failure as an option. This necessitates tough conditionality and rules for orderly bankruptcy. On the other hand, Mr. Trichet – really standing for the "South"? - does not stop claiming that "we are all in the same boat". In that sense, a member state should not be left alone if it is in trouble. In the extreme, this view implies that there is neither a plan B necessary nor is there any floor to the rating of collateral foreseen at the ECB.[2]

In the wake of the October 29 European Council, the tensions between the "North" and the "South" came back on the scene. The aim of policy should thus not only be to prevent failures, rather it should also prepare for it. An EMF could be based on permanent EFSF. Since the available collective action clauses are insufficient, there is the necessity of mopping up law.

It has to be mentioned that there are a couple of differences in sovereign and private defaults. Therefore, sovereign-debt crisis are more complicated to deal with, since instruments to handle the situation in an orderly way are much more limited than in the case of private debt. In the latter case, the problem can be solved by liquidating the borrower's assets and, referring to corporations, dissolving the organization (Gianviti et al., 2010, p. 19).

These preliminaries should serve as the background against which missing or redundant and/or unworkable elements within the Commission package can be identified.

3. Missing or redundant/unworkable elements within the Commission package

Unworkable? SGP sanctions and voting

An important issue is to what extent quasi-automatic sanctions and a reversal of the burden of proof in the EDP would influence market perceptions. It is conceivable that in this case alone the triggering of the EDP could lead to major reactions by market participants. However, this problem is also inherent in the proposals referring to the permanent crisis resolution mechanism – although in a few of the Sovereign Debt Restructuring Mechanism (SDRM)-type proposals this is intended to be mitigated by inferring the role of a "judge" to the SDRM (section 3). On the other hand, such a change in processes of this kind – just like the European semester – would clearly signal a paradigm shift towards more serious budget coordination that could be rewarded by the markets.

Missing: strong incentives to stick to the rules

A *more comprehensive framework of ex-ante policy coordination* including a "European Semester[a1]" has been decided by the Council. Procedural changes to the Semester may be implemented after the European Parliament has voiced its concerns in the coming months. In the latter it would examine the individual countries' budget plans and then issue recommendations for corrective action based not only on each country's fiscal trajectory, but also on the aggregate implications of the individual plans. This framework aims at keeping individual countries to their fiscal targets and at avoiding persistent and large intra-euro area imbalances. But it is left open what could actually force countries to change their budget plans according to the Commission's recommendations in times of conflict. The

[2] I gratefully acknowledge comments from Daniel Gros on this issue.

Commission also suggests that countries exceeding the SGP deficit ceilings should be forced to set aside funds in interest bearing deposits. But again: "what makes us think that these interest bearing deposits would be enforced, when the fines already envisaged in the SGP have never been levied" (Annunziata, 2010)? Commission proposals would then have to be rejected by a qualified majority of the Council. But in scenarios like the current one in which the qualified majority of member countries have preferences which go beyond the notion of EU economic governance as a mere hardening of the SGP, credible enforcement of budget discipline might become a difficult task even in good times (Belke, 2010, p. 15).

The simple but obvious and central problem inherent in both the old and the proposed "new and improved" SGP is that *none of them disposes of any mechanism to override national sovereignty*. Taxing and spending decisions rightly rest with the elected representatives of each individual country - and since there seems to be no appetite for full political union at least in the former hard currency countries (Annunziata, 2010, Neumann, 2010), this is quite safely not going to change.

Missing: clear definition of the IMF's role

Is there any, and if yes, what role for the IMF? The H. van Rompuy Task Force enumerates the role of the IMF among the issues to be addressed for a new future permanent mechanism. Especially with an eye on the very strong conditionality under which programmes like a permanent crisis solution mechanism should operate. The IMF is mentioned neither in the COM proposal nor in the recent EP positions.

Critical but unavoidably missing (after end-of-October EU summit): reversed qualitative majority voting on SGP sanctions and withdrawal of voting rights

The results of the recent EU summit have to be appreciated if indeed a crisis solution mechanism which really deserves its name will result in the end. It would put an end to the large-scale problems described in section 1 – especially because it would terminate the role of the ECB as the bad bank of the euro area. The very existence of this mechanism would be much more important than the withdrawal of voting rights in EU committees, if a country repeatedly cheats with respect to the deficit rules. In terms of game theory, the threat of withdrawal of voting rights has been strategically employed as a "whipping boy", in order to dispose of some items to sacrifice for a package deal.

What is more, a hardened Stability and Growth Pact has to be regarded more as a complement than a true alternative to a successfully designed government insolvency mechanism. Hence, one could feel legitimized to argue that an only partial hardening without „automatic" sanctions, as it is now envisaged, is acceptable. Particularly since the majority of the proposals by the EU Commission to provide the SGP with sharper teeth, is still included in the package (Belke, 2010).

Unworkable: differentiation between proposals for eurozone and non-eurozone countries

With regard to economic policy, the differentiation between proposals for euro area and non-euro area countries is likely to become an issue. Such a differentiation is made in the documents drawn up by the Commission and is supported by the H. van Rompuy task force: potential sanctions and conditionality will play a lesser role with non-euro area countries. Also scoreboard thresholds may be different between euro area and non-euro area countries.

Whereas leaving room for convergence might be a plausible first glance argument in favour of this unequal treatment, the question looming on the horizon is whether and by how much an economic "core Europe" could decouple itself from the non-euro area countries and, by this, indirectly lower their probability to enter the euro area in the future. It is thus overall plausible to take "into consideration the very close interconnections with non-euro area economies, especially those that are expected to join the euro area, as part of the new multilateral surveillance framework and the enhanced instruments of the SGP and, in particular, a stronger focus of the MTFO" (Feio, 2010).

This issue is relevant since - with respect to the issue of a crisis solution mechanism (on which the EU Commission is silent) - Mr. Feio is correctly claiming that it should also be carefully assessed whether non-euro area Member States could possibly join the European financial stabilisation mechanism on a case-by-case basis and after fulfilling pre-defined criteria.

Unworkable: interpretation of Art. 125 TFEU as a strict "no bail-out clause"

Upon closer examination, one reading of the Article is that countries like Greece do not have a legal entitlement for guarantees or even payments from the Union and other member states but that it does not prohibit the former. However, the EFSF framework has de facto been established anyway. There is thus a clear need of changing the factual constraints. Otherwise Art. 125 TFEU would become toothless. In this sense, the "no bail-out" rule under a solution like the EMF would be more credible than the "no" under Art. 125 TFEU.

Redundant: a scoreboard establishing a set of indicators revealing external and internal imbalances

Basically, it makes much sense to avoid 'harmful' macroeconomic imbalances. But up to now there is no technical solution for the problem of determining the exact threshold beyond which an existing imbalance is 'harmful' and to whom it is harmful ex ante. However, there is point in more generally monitoring large external deficits (and also the share of foreign debt in overall debt figures playing a role within the Commission package). The latter make countries prone to a 'sudden stop' to the capital inflows and the connected dangerous dislocations in financial markets potentially spreading all over the euro area (Gros, 2010a). Since the public deficits are frequently driven by private deficits – as in the cases of Ireland and Spain – also the Eurosystem bears a large part of responsibilities in allowing bubbles in national housing markets and the associated increases in private debt to develop (de Grauwe, 2010).

It directly follows that the best policy response does not seem to be a narrow focus on competitiveness indicators, but rather on the prevention of underlying causes of the imbalance, which are usually divergences in domestic demand (often driven by credit-financed real estate and/or consumption booms). Or even wait for the automatic reversal of the imbalances. This might be a favourable and dominant strategy with an eye on the German example according to which current account surpluses led to a stimulus for domestic demand which, in turn, supports wage growth, ceteris paribus lowers competitiveness and the current account surplus. Hence, one of the basic insights of international economics is that *current account imbalances* are *endogenous* and driven by autonomous and complex savings and investment decisions. What is more, it should be clear that a specific country cannot import more than it exports for an unlimited time and the other way round. If at all, thus, any focus should be put on the duration of imbalances not on the imbalances per se. But again: who should decide on the threshold? And on what basis?

Moreover, a rigid and mechanical application of such a large assemblage of different indicators may lead to ambiguous results and, thus, lead to confusion. This, in turn, would negatively impact on the effectiveness of monitoring and potential sanctioning. For instance, how to react if some indicators point at one direction and a couple of others at another? How to aggregate the evidence? If aggregation is agreed upon, what are the weights? Anyway, most cases in which member states get into difficulties cannot be exactly traced back to the empirical realization of one or another economic indicator. Instead, these cases are related to inadequate governance of an array of imbalances prevalent within a country (Bruegel, 2010, Fahrholz and Wójcik, 2010).

Finally, a definite strength of the proposals contained in the EU Commission package is that it is *not* treating surplus and deficit countries *symmetrically*. By this, it proves to take a true global perspective and to acknowledge the negative effects on the *international* competitiveness of the euro area that would emerge with respect to the rest of the world in case of adjusting competitiveness indicators in a symmetric fashion (Belke, Schnabl and

Zemanek, 2010). Opponents to this view appear to be driven by the (wrong) perception that the deficits of some member countries are numerically exactly offset by the surplus of others, i.e. in a symmetrical way. Of course it is tempting now to apply closed economy reasoning and to suggest that both enhancing competitiveness of the deficit countries and lowering competitiveness of the surplus countries lead to a reduction of imbalances, since competitiveness is always defined in relative terms. But the euro area is faced with an increasing degree of globalization and would thus as a whole really suffer welfare losses from any competitive adjustment 'to the middle', in terms of an overall loss of competitiveness for the entire area (Bruegel, 2010).

To summarize, as frequently warned by economists like Richard Baldwin, the EU Commission and national governments are expected to have great difficulties in steering trade and current account deficits. Concrete numerical goals as also discussed at the recent G 20-summit are not more than catchwords. Hence, it turned out to be a nearly safe bet that governments agreed upon more than the mere closing declarations, because anything else would be too difficult to implement.

European semester: unworkable element?

The European semester has the potential to be extensively discussed by EU leaders. Thereby, the treatment and integration of national parliaments disposing of budgetary prerogatives will continue to represent a critical issue. As experience shows, the national parliaments tend to insist on exercising their rights which makes a European peer review of draft budgets prior to the national budget process an event of low probability in the near future. This creates a constitutional problem which could not be solved by integrating the European Parliament. These problems notwithstanding, the European semester would even be useful for an *effective coordination by means of the exchange of information and creating transparency of information flows* (Belke, 2010, and the sources cited therein).

Before finally addressing some general considerations, one should stress that both concessions - the commitment by the EU Council to promise the UK lower growth rates of future EU budgets and the planned specific treatment of the costs of structural and pension reforms in the CEECs within the deficit procedures - represent justifiable sacrifices to arrive at a sound "package deal" at the October EU Summit – mainly due to their sustainable effects on future public finances (Belke, 2010).

General remarks

The European Council agreed to follow most of the proposals included in the EU Commission package, i.e. to tighten the SGP and to set up a system aimed at reducing macroeconomic imbalances produced by a lack of convergence of economic policies within the euro area. It obviously took the view that the main source of the euro area debt crisis has been the "misconduct" of national governments which have permitted their budget deficits and debt levels to explode and have implemented too few measures to avoid divergent movements in their economies. While this view is partly true, it clearly neglects the "hot potato game" characterizing the financial crisis, i.e. the fact that unsustainable increases in private debt (of households and financial institutions) forced many governments to bail out the private sector (and, in the end, forced the ECB to collect the pieces). Excessive bank credit enables the emergence of these bubbles and made them more intense, as could be seen in Ireland and Spain. In the long run, only the central bank but not the governments can control bank credit, the conditions for lending and the development of unsustainable private debt levels (de Grauwe, 2010).

Reforms of the economic governance in the euro area should therefore not only focus on the serious responsibilities of national governments - as done in the Commission package - but also on those of the European monetary authorities, and in particular those of the ECB. After the Lehman collapse, European policy (including monetary policy and the EU Commission package) followed the principle that the insolvency of governments and banks had to be prevented under all circumstances and accepting any costs. With an eye on the sustained bond market turbulences, this way could be labeled as a fiction. The compromise agreed upon at the European Council meeting of 28-29 October clearly turns away from this principle and, thus, should be basically welcomed. The status quo European rescue package has to be urgently substituted by a permanent crisis mechanism. And this has to do with current ECB monetary policy: the level of the current ECB main refinancing interest rate shields Ireland and Greece from insolvency. This is an important aspect neither taken into account nor explicitly tackled within the EU Commission package.

All the discussions about a potential „bail-out“ of countries within the framework of the current rescue package neglect the fact that a much larger bail-out can be read off the ECB balance sheet. With a focus on the purchases of "toxic" government bonds by the ECB within the SMP, it can be argued that the ECB intervenes in “dysfunctional markets” for government debt in a sterilized but completely discretionary manner. This *must* effectively lead to a redistribution of risk among member states (Belke, 2010).

However, an even more alarming aspect the public might not be sufficiently aware of is that the ECB supports the respective member countries and their banks in the framework of its ordinary monetary policy operations. The ECB grants the troubled and distressed commercial banks to refinance hundreds of billion euro, i.e. 40 to 50 percent of GDP for Ireland respectively Greece, at a one percent interest rate. As expressed in the FT Editorial from November 16, 2010: “Irish banks only survive thanks to European Central Bank lending: they currently suck up about a quarter of the ECB’s liquidity provision. … But the sickliness is part of why sovereign yields have spiked, troubling the bond market of other peripheral European states.” Without this transfer of nearly free money, both countries would almost certainly have gone bankrupt some time ago. Assuming that Greek banks should have to pay the same risk premium as the Greek government, ECB lending to Greece amounts to a subsidy worth more than the transfer from the EU Structural Funds (Gros, 2010b). Notably, referring to QE by the Fed is no excuse here, because US QE cannot at all be compared to the quasi-QE programmes conducted by the Fed, since the latter does not target its bond purchases to, for instance, Florida or other specific federal states.

As mentioned in section 1, the ECB is now the buyer of only resort for Irish bonds, possibly the only policy institution able to prevent the collapse in Irish and Portuguese bonds from spreading. But this may imply that Mr. Trichet has to ignore opposition from within the ECB council to the ECB’s bond-buying program and further expand purchases of sovereign assets.

Taking these considerations as a starting point, it seems fair to state that the Commission/Euro Group *do not* have submitted a proper adjustment programme which really covers the central issues. Just changing the SGP which represents a significant part of the Commission package is not *the* issue – this appears to be not more than a sideshow which will not lead to significant solutions to the large-scale problems of the euro area described earlier. A further central problem would be the democratic legitimacy of imposing fines according to the exact realization of figures. This in itself speaks in favour of a bottom-up approach in the shape of, for instance, fiscal limits hard-coded into each country’s legislation in the form of automatic, binding and unchangeable rules (Belke, 2010). Hence, one should deal with the question neglected by the Commission package: "What happens, if …?". Let us now check what (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable.

4. What (if anything) is missing outside and beyond the proposals in order to make the whole package of governance reform complete and workable?

Eurobonds – really missing?

Mr. Juncker recently proposed a European bond. He said he would make a formal proposal for a common Eurozone bond. He is quoted as saying: "It's an intelligent way to keep economically weaker euro countries attractive for investors in the future." However, this argument should not be bought completely. The only argument to justify the introduction of Eurobonds is to defragment the EU bond market and to create an alternative for Chinese (or Russian) investors who up to now still invest in safe T-bills – in spite of increasing doubts in the US macro policy stance and their fear of returns being inflated away after a while. Since the euro area should be prepared to go for larger current account deficits if China will stick to its export model also in the future (as all projections say) and the US really strive for lower deficits, defragmenting bond markets might be a contribution to lower global imbalances (in accordance with the position by Mrs. Berès on the crisis resolution mechanism). The arguments speaking against the introduction of Eurobonds are broadly similar to those brought in against the Securities Market Programme (SMP) and, hence, shall not be enumerated again.

Missing? Bank recapitalization as a condition-sine-qua-non

As shown in section 1, large-scale problems of the status quo appear at the surface in the euro area because there has not been any solution to the deficiencies which drive the crisis, among them the still alarming stances of the Spanish real estate sector and Greek public finances. In this context, it is remarkable that the proposals do not tackle at all the still *significant undercapitalization of the European banking system* – a second important driving force of unsettled financial markets. Gros (2010), for instance, reports based on euro area statistics that for every capital loss of one euro held by some euro area bank, there is about €20 of doubtful debt (liabilities including interbank debt).

But, strikingly, all proposals implicitly assume that European funding will be used only to bail out governments which in turn might apply these funds to bail out their own banks. The word "bank" does not even appear in any of the proposals although the banking issue is deeply connected with the state of public finances and the necessary volume of an emergency fund. But, taking the 20:1 liability-capital ratio in the banking sector as a starting point, this way of handling this critical issue implies that the public funding requirements within a potential crisis resolution mechanism may become much higher than if undercapitalization would be dealt with directly (Gros, 2010). The proposals should at least mention these fundamental relations and, even better, explicitly combine their concepts with a hint at the need for continuous rigorous stress testing of euro area banks and subsequent mandatory recapitalization (as long as Basle III is not fixed but only agreed upon by the G-20). It is necessary but not sufficient to blame the Club Med countries for unsustainable fiscal policies.

However, these insights have to be carefully weighed against that fact that the root of the problem in Ireland (i.e. the source of doubt about its solvency) is the government's overly strong commitment to bank bondholders at any costs. This might translate into a great risk for the taxpayer since ECB Vice-President Vitor Constâncio has publicly considered that EFSF money could be used to back Irish banks. This paper argues that this would, however, be a mistake and, thus, sovereign bonds will then continue to be under pressure. "It would also give an official EU imprimatur on Europe's dirty secret: public treasuries will do anything to make private bank creditors whole. Committing this mistake to stop the contagion of panic in government debt will only make it worse. Propping up banks whose losses have still not been fully realised cannot possibly improve sovereign creditworthiness" (FT Editorial, November 15, 2010).

Missing in the Commission package: establishment of a crisis solution mechanism

The European Monetary Fund

The EMF and the EP position

What has certainly been missing within the proposals by the EU Commission in order to make the whole package of governance reform complete and workable is the scheduled *establishment of a crisis solution mechanism*. However, this lack seems to be resolved by the agreements reached at the recent EU Council.

In accordance with Feio (2010), this briefing paper argues that one should "establish a permanent mechanism or body (a European Monetary Fund), after due examination of its pros and cons, which should not take more than one year, to be an overseer of sovereign debt developments and to complement the SGP as a mechanism of last resort for cases in which market financing is no longer available for a government and/or member state exposed to balance of payments problems; it shall be based on existing mechanisms (the European Financial Stability Facility, the European financial stabilisation mechanism and the European balance of payments assistance instrument) and shall include clear rules inter alia on the following aspects: a) membership criteria, such as fulfilling the minimum requirements for national budgetary rules/institutions, b) decision-making procedures and funding, c) conditionality for exceptional loans, d) monitoring and e) resources and powers; such a mechanism should not limit the powers of the budgetary authorities to establish the EU budget at an appropriate level, should avoid moral hazard and be consistent with state aid principles and the consequences of ignoring them." This paper later on checks whether these conditions are fulfilled in case of the EMF.

The crisis solution mechanism must not necessarily take the form of an EMF but could in principle also consist of a *Sovereign Debt Restructuring Mechanism* (SDRM) à la IMF (Krueger, 2002, Rogoff and Zettelmeyer, 2002a,b) which was originally designed to cope with defaults of emerging market countries such as Argentina. But the facts that (a) the SDRM seems to take more a (softer) role of a "judge" between creditors and debtors and (b) there is a legal vacuum how to organize orderly and unscheduled default in the euro area (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries which have been addressed by the SDRM point at the necessity of installing an EMF.

EMF substituting ECB as the bad bank for the euro area

A European Monetary Fund according to the model designed by Daniel Gros and Thomas Mayer might well represent the blueprint of an orderly sovereign default mechanism which really deserves its name (Gros and Mayer, 2010a). It would contribute decisively to release the ECB from her role as a bad bank and to let the debtor countries and the creditors participate in the costs of sovereign default according to the costs-by-cause principle. Otherwise, the reputation of the ECB would be damaged too much and one would slip deeper and deeper into a transfer union.

Even more important from a strategic point of view, an EMF does not systematically discriminate against smaller countries and takes away any German-French dominance from the mechanism (smaller countries complained about both issues after Deauville). An IMF mitigates the currently increasing tensions between larger and smaller member countries, the latter feeling patronized by the former. This is because every member country would, according to the envisaged financing mechanism, be called to account proportionally to its GDP if it breaches the Maastricht fiscal criteria. However, its probability of realisation could be larger if it would not be seen as a competitor of the IMF on an international level and especially so by US officials (for a deeper discussion of the IMF-EMF relationship see Belke, 2010).

Status quo only moves the day of reckoning

The results of the most recent EU summit suggest that politicians finally realized that unlimited financing of insolvency-prone countries and banks will not be tenable any more.

This change of mind constitutes the ultimate merit of the agreements made during the summit. Any hardening of the SGP could be unlimitedly pursued and are welcome as a complement to an EMF.

But independent on whether the rules are endowed with sanctions or not and on the case costs-by-cause principle, the costs of avoiding default still accrue in any to the community of the remaining member states. The default-prone governments still keep their threat potential since their default would cause systemic costs which are generally perceived as prohibitively high. What is more, the solvency of the saviour countries has to be safeguarded which tends to increase the costs in cascades.

Seen on the whole, thus, the status quo has not been an effective solution for insolvent debtors; it merely frontloaded the day of final reckoning to some day in the future. In addition, it makes debtor countries hooked on it. Since access to the ECB's ordinary monetary policy operations is the cheapest way of refinancing, the distressed banks will even steadily increase their dependence from this source (Gros, 2010b). This process will finally lead to a concentration of bad risks on the ECB balance sheet as described in detail in Belke (2010).

The ECB and the EFSF have assumed the allocation function of capital markets, since they decide in a completely discretionary manner which countries and which banks are granted access to (re-) financing at which costs.

The European Monetary Fund: a preferable blueprint

Let me now briefly elaborate on how to interpret the EMF proposal by Gros and Mayer which incorporates many elements not included in the EU Commission package but is in strong compliance with Feio (2010) (Belke, 2010a, Gros and Mayer, 2010).

Pre-empting the end game, i.e. recognize sovereign default as "ultima ratio" for a country in financial distress, and *limiting moral hazard of debtors and creditors* by charging the former for excessive deficits and debt and imposing haircuts on the latter for imprudent lending are among the *key goals* of a European Monetary (Stability) Fund. In this respect, the EMF proposal is in accordance with Feio (2010) ("such a mechanism should … avoid moral hazard …").

The *key principles* of the EMF are as follows. It allows sovereign default at minimal cost in terms of systemic stability and public expense. It puts a floor under the market price of debt in default through guarantees and/or debt exchange. This floor contains contagion as the downside for debt of other countries is also limited (note that Spain's public debt share at GDP amounted not more than 60 percent at the start of the debt crisis). Concerning haircuts, the nominal value of debt after the haircut shall amount to 60% of GDP of the defaulting country. The idea is that telling markets what the haircut will be would keep the defaulted bonds tradeable in secondary markets and prevent complete market chaos. And what is the benefit to the creditors? The only alternative for a private creditor would be a much bigger haircut. Gros and Mayer think of GDP warrants to align the interests of creditors and debtors. Since the EMF might become the sole or at least the principal creditor of the defaulting country (directly through exchange or indirectly through guarantee) the political leverage of EU framework can be applied to discipline the "debt sinners" (Belke, 2010a, Gros and Mayer, 2010).

Stage 1 in debt workout consists of guarantees granted by the EMF. The typical situation to start from is a country in trouble which has lost its market access and financial markets which are area wide in turmoil because the size of losses is uncertain. In this case, the EMF agrees with the country on the adjustment program and provides adjustment funding. The EMF puts a floor on the value of debt by guaranteeing x% of payment obligations (with x% of debt = 60% of GDP). As a part of an EMF-led adjustment program, the country negotiates restructuring with private creditors. GDP warrants are again a key element. Creditors whose claims are due during the adjustment program get the same treatment (Belke, 2010a, Gros and Mayer, 2010).

There are strong *incentives for a stage 1 debt workout* because the guarantee prevents the price of debt from undershooting and, hence, potentially fatal mark-downs in the trading book of creditors. The debtor country negotiates in good faith with creditors on re-structuring as this paves the way for adjustment funding. The creditors negotiate in good faith with the country as they can expect to raise the recovery rate above the guarantee rate. The question here is whether GDP warrants are the best way to align incentives. These negotiations could well be accompanied by rules which should be conducive to relatively early engagement of creditors and debtors in an exchange of information and views on the current situation in order to reduce the uncertainty of the creditors (Gianviti et al., 2010, Krueger, 2002).

As *stage 2 in the debt workout*, Gros and Mayer (2010) provide for a debt exchange. If adjustment is unsuccessful, the EMF becomes the sole creditor of the insolvent country through (mandatory) debt exchange. The EMF imposes further conditionality, i.e. limits on new borrowing, on the insolvent country so as to assure that the country can repay the EMF. Any European mechanism would need to include measures to safeguard the impartiality between creditors and debtors of the debt restructuring process (Gianviti et al., 2010). Any breach of the conditions and/or the default on the EMF would mean a breach of EU Treaty obligations. Hence, leaving the euro area and ultimately dispensing with the benefits of the EU are the dire consequence.[3] This part of the EMF proposal fulfills the demands outlined in Feio (2010) that the new mechanism should include rules for conditionality for exceptional loans and that one needs clear rules for the powers of the Fund.

An important element of the EMF procedure is represented by the *disincentives to move to stage 2* of the debt workout. This is because the latter would imply a longer-term loss of access to capital market, reduced access for the banking sector to ECB funds as government bonds would no longer be eligible as collateral, a loss of political sovereignty and a potential exit from EMU and EU. This is again in strict accordance with the position presented in Feio (2010) ("such a mechanism should … be consistent with state aid principles and the consequences of ignoring them").

The EMF could *substitute the status quo solution consisting of a combination of the EFSF plus the ECB*. The EFSF now exists (without any Treaty change!), but only for sovereign default prevention. And the ECB is engaged in "debt exchange" in "dysfunctional" bond markets. This means that the *redeployment* of the 440 billion Fund would be more than enough for a start-up funding of the EMF and, even more important, would take the ECB out of the business of lender of last resort to EMU sovereigns. In this respect, the EMF proposal closely corresponds to the position described in Feio (2010): "it shall be based on existing mechanisms".

The *EMF funding in the future is by automatic 'sanctions'*. Gros and Mayer propose an extra levy on countries that breach the Maastricht criteria: X % of excess debt defined as actual debt (% GDP) – 60% with $X < 1$ and Y % of excess deficit defined as actual deficit (% GDP) – 3% with $Y > 1$. This property closely corresponds to Feio: "the mechanism … should include clear rules inter alia on … membership criteria, such as fulfilling the minimum requirements for national budgetary rules/institutions … and funding …" and " … clear rules for … resources …".

The EMF should be endowed with *professional staff and independence*. According to Gros and Mayer, the staff of the EMF should be independent and make assessments free of political imperatives. The open question is whether it should be a new institution or a special, shielded, part of Commission. Also rules for decision-making procedures as requested by Feio (2010) are not clarified up to now. Failures of the pre-WWII Gold

[3] Fahrholz and Wójcik (2010) argue that specifying conditions for leaving the EMU would work through several channels. Overall, making exit costs and procedures explicit would raise the perceived costs of a legally possible exit relative to the short-term political costs of economic adjustment. This would be a deterrent to brinkmanship, stimulate fiscal discipline and lower the scope of the inherent negative externality problem within the euro area. Haede (2010), however, takes a more critical view on this issue.

Standard led to the IMF. An analogue is the EMU crisis which might lead to an EMF (Belke, 2010a, Gros and Mayer, 2010).

Concerning the "EMF versus IMF" dichotomy, Daniel Gros is right in arguing that a "virtual EMF" could be carved out of European Department of the IMF. Since there might be an incentive for a unified euro area representation within the IMF, a natural corollary would be that EFSF would then represent euro area interests inside the IMF (Gros, 2010c).

Although they appear rather similar at first glance, there are a couple of *key differences between the EMF proposal and the ECB's crisis management institution (CMI)* worth mentioning here (on the CMI which has been proposed by the ECB without any recourse to the necessity of a treaty change see Belke, 2010): within the ECB proposal, sovereign default is not an option and financial support comes at penalty rates. An important question is whether the CMI would really conduct purchases of debt in 'dysfunctional' markets at "market" prices. A well-informed guess would be that these are not true market prices if the CMI and/or the ECB are the buyers of last resort even if the bonds are bought at less than at par (Belke, 2010a, Gros and Mayer, 2010).

There are further *problems inherent in the ECB's suggestion*. Without default option, the debt exchange likely occurs at prices which are very favourable for creditors and, in addition, the ECB will remain the buyer of last resort for the time being. Moreover, it remains unclear what happens when a country defaults on claims held by the CMI. Finally, as noted by Gianviti et al. (2010), the "ECB's request for preferred creditor status" within the CMI might prove counterproductive, since in this case private creditors would still be plagued by the risk of losing their money. Hence, the main question is whether the European Parliament and other institutions should really spend more political capital on developing an elaborate framework for 'economic governance' or whether it should focus on reinforcing discipline by making failure possible.

Reducing contagion is key for financial market stability in the euro area. The mere existence of EMF would have reduced the potential for contagion since investors would have known that there would not have been any significant losses on Spain with a debt-to-GDP ratio of not significantly more than 60 percent at the start of the debt crisis (Belke, 2010a, Gros and Mayer, 2010). Finally, the EMF could also engage in preventive action if its prior analysis has shown weak policies. This would correspond to the request of clear rules for monitoring in Feio (2010).

EMF – Legal issues

An EMF would (probably) be *compatible with the Treaty* (i.e., necessitate only small changes of it). A sovereign insolvency mechanism to which the EU Council has committed itself could represent a half-way compromise between a "complete liquidation" and infinite financing of weak countries (and banks). This mechanism has to embrace a controlled rescheduling or even a debt restructuring in order to avoid the emergence of addicted countries being on the drip in the periphery of the euro area (Gros, 2010b). An EMF, for instance, fulfills these conditions – even if one would not be forced to call it "EMF".

Haede (2010) comes up with a quite skeptic legal evaluation of a Monetary Fund (Haede, 2010). However, it should be argued that higher payments to the EMF linked to excessive deficits are not to be considered as 'sanctions' and, thus, not as compatible with the Treaty, but as contributions to a mutual insurance scheme. This makes them compatible with the basic EU principle that any 'sanction' must be somehow related to the aim that is supposed to be achieved. Sanctions such as withdrawing voting rights or zero interest bearing deposits (which go to the EU budget) have no direct link to the aim, which is financial stability. Also from this point of view, the Commission package seems to be unworkable (see section 2).

If one follows the implicit objectives of the Council and wants to keep Treaty changes to a minimum in order to avoid any significant opposition from the member countries, there are at least three alternatives (for the first two see in detail Gros, ó Broin and Kaczyński, 2010): (1) one could enlarge the scope of Art. 122 TFEU by adding "or if the stability of the euro is threatened"[4], (2) one might add a reference to 143 TFEU in 136 TFEU and, by this, enlarge the scope of Art. 143, or simply delete the term "with a derogation". According to Art. 143 TFEU, only member states with a derogation (those which have not adopted the euro) can receive financial assistance to deal with balance of payments problems (Giavazzi and Spaventa, 2010). In order to structure a 'planned insolvency' one could refer to Art. 114 TFEU (dealing with the completion of the internal market by adoption of harmonising legislation).The probability of getting through with a very small Treaty change thus seems to be rather high. However, a couple of uncertainties still have to be tackled and resolved.[5]

Seen on the whole, thus, legal concerns should not represent a main barrier for the materialisation of an EMF, particularly since it was a core ingredient of the summit agreement that Art. 122 TFEU shall be extended. The van Rompuy Task Force should rather spend its time until December 2010 to clarify, when exactly the conditions are fulfilled to claim that „the whole euro area is in danger" and to pull the trigger for debt exchange and how to cope with the reactions of the financial markets which may anticipate the date of reckoning coming even beforehand.

Problems with EMF debt workout, stage II

The fact that in the future *private creditors will take a share in the costs of a default* is believed to be the main trigger for panic spreading on the markets in the previous two weeks. The EU heads of state have already decided that it will end up like that. Until their next summit in December 2010 proposals shall be available *how* this will be managed in the time after mid-2013 when the current rescue package will run out. The uncertainty about what will happen thereafter, the fear to be asked to pay up before that date and that collective-action clauses are still in the debate are making investors extremely nervous.

What is more, financial market actors could speculate against a country as soon as the expectation manifests itself that it will utilize the crisis mechanism. Some even argue that the crisis would be even caused by these linkages. Also the banking system of the default-prone country might "collapse" since it is dependent on government guarantees. The social and political consequences of such a development are incalculable. In the end, exactly the opposite of the original intentions would be reached: speculative investors would take advantage of the current situation while many small savers suffer damage. Over the previous days investors have already withdrawn their money from endangered countries like Ireland und Portugal (Bini Smaghi, 2010).

However, this view appears to be overly pessimistic because the available academic literature on the effects of creating a sovereign-debt resolution mechanism on bond yields tells us that the introduction of rules (with the involvement of creditors) for coping with sovereign default will corroborate the inclination of markets to differentiate between high and low quality borrowers and to evaluate loans and bonds accordingly. An insightful study in this respect is Eichengreen and Mody (2004) who examine the implications of including collective-action clauses in loan contracts for borrowing costs. For a sample of some 2,000 international bonds, they compare the spreads on bonds subject to UK governing law which typically include *collective-action clauses*, with spreads on bonds subject to US law, which do not. Contrary to the assertions of some market participants, they find that collective-action clauses in fact *reduce* the cost of borrowing for *more credit-worthy* issuers who appear to benefit from the ability to avail themselves of an orderly restructuring process. In contrast, *less credit-worthy* issuers pay *higher spreads*. They conjecture that for less credit-worthy borrowers the advantages of orderly restructuring are *offset by the moral hazard and default risk* associated with the presence of renegotiation-friendly loan provisions.

Without much ado a straightforward implication would *ceteris paribus* be for the euro area that the introduction of rules for dealing with sovereign default would reinforce market

[4] Note that the German Constitutional Court is about to check whether this would impact on the "no-bail-out" clause in Art. 125 TFEU and, hence, change the nature of monetary union and transform the latter into a transfer union. See Haede (2010).

[5] Gros, ó Broin and Kaczyński (2010) enumerate examples in which the ratification even of a minimal Treaty change might have to pass certain obstacles.

discipline and support "the goal of sustainable public finances laid down in the European Treaty, and thereby to the sustainability of the euro itself" (Gianviti et al., 2010). However, current and future research should urgently focus on the *applicability of the ceteris paribus clause*. As mentioned in section 1, there appears, for instance, to be a legal vacuum how to organize orderly and unscheduled default in the euro area (in contrast to the detailed descriptions underlying international bonds issued by emerging market countries). Moreover, empirical results by Bradley et al. (2010) indicate that the judicial injection of uncertainty into the meaning of crucial contract terms is priced by capital market participants in a predictable way. Decisions that increase the risk of repayment by sovereigns raise the rate return sovereigns must pay in order to attract international capital. Decisions that reduce this risk, in turn, tend to lower the cost of capital that sovereigns face. At first glance, this might contradict the findings by Eichengreen and Mody (2004). However, the main question to be answered in this context is, of course, whether the introduction of rules for dealing with sovereign default enhances or lowers uncertainty about repayment.

A second argument against the (pessimistic) Bini Smaghi view might be that the new European crisis resolution mechanism could be *designed* in a way that private creditors would not have any reason to panic. For instance, the new crisis resolution mechanism could be formulated in a way that it is *not applicable to old debt but only to new credit* from mid-2013 on. Such kind of a solution would correspond to suggestions put forward by Germany's finance minister Mr. Schaeuble: as soon as a country gets into payment difficulties, an austerity and stabilization programme will be activated – just like in spring this year in the case of Greece. As a first step, the *maturity of those bonds could be prolonged* which become due within this critical phase. If this is not effective, private creditors would have to accept haircuts on their claims as a second step. In return, they would be granted guarantees on the remaining parts (both measures are also main ingredients of the EMF proposal).

Involvement of private creditor participation is, for instance, also supported by Bruegel (see Gianviti et al., 2010) and the German Council of Economic Advisors (Sachverständigenrat, 2010). Bruegel recommends that euro area countries should be allowed to issue new bonds only if a fixed crisis resolution mechanism including an involvement of private creditors is in place. The German Council of Economic Advisors even goes a step further. It proposes that private creditors should participate in a stabilisation programme if the EU Commission has proposed sanctions against a deficit country. This proposal refers to countries which have actively offended the rules of the SGP but not to governments which got into payment difficulties through no fault of their own, for instance, by a financial crisis. Whereas the more general line of Bruegel deserves support, the latter recommendation might go too far. It appears to be too early to involve private creditors before payment difficulties have occurred. Moreover, for all practical purposes it turns out rather difficult to distinguish whether a country got into distress through no fault or fault of their own. Seen on the whole, thus, this paper argues that private creditors should (be forced to) take into account (by an incentive structure like the EMF) that a solvency problem postponed is a problem made intractable and that it is better to make a painful break than draw out the agony.

EMF: Further caveats

The remaining caveats with respect to the EMF proposal are both related to the EMF's "trigger of debt workout stage 2" issue. Another open flank of the EMF proposal consists of the fact that it is not clear up to now how and whether to treat countries suffering distress due to excessive private and public consumption (e.g., Greece) differently within the debt workout scheme than countries whose budgetary stance suffers from collapsing banks (e.g., Ireland). Finally, the issue of how much authority creditors like the EMF have over the future stance of the primary surplus and, hence, the extent of austerity in the first period after restructuring still remains critical. This is because the rewards to the government's taxing authority depend on the quality of institutions and the citizens' allegiance which in turn is related to sound principles of democracy (Gianviti et al., 2010, Raffer 1990). These are truly decisive questions, also addressing the proponents of an otherwise preferable EMF-type solution.

5. Is an EMF a realistic option? Perspectives after the EU summit

How large is the probability that something like an EMF will substitute the current 750-billion euro rescue package? Or is this issue put on the cold storage or even procrastinated? The facts point at a high probability that this issue will be decided upon in the near future. The Germans have made a package (deal) between the prolongation of the current mechanism which will run out in 2013 and the decision about a new follow-up system. The willingness of France to talk about a Treaty change is strikingly new. But Germany and France might have underestimated the fact that there are 27 national governments within the EU and one needs the support of each of them. As could be observed, for instance, at the most recent EU Summit, this will be a hard way to go. From a purely legal perspective, there are only a few changes in paragraphs necessary. However, these changes have to be supported by 27 governments and have to pass the parliaments and potentially even referenda.

Moreover, as already argued above, the EMF's probability of realisation could be larger if it were not be seen as a competitor of the IMF on an international level and especially so from the US. Will there be enough political leadership to cope with implicit US pressure with an eye on the fact that IMF involvement is not explicitly dealt with in the Commission package (section 2)? At the same time it can be shown that the IMF and the EMF can well co-exist (see section on the EMF in this paper).

Our considerations in the section on "EMF – legal issues" have demonstrated that a slight change in Art. 122 should be enough to satisfy the German Constitutional Court and at the same time provide a solid legal basis for the "new post-2013 permanent EFSF" (Gros, ó Broin and Kaczyński, 2010) which will probably not be explicitly referred to in any Treaty changes. The new mechanism could then probably be developed and made effective on an intergovernmental basis. In case of too much resistance against an EMF as such, it might not necessarily involve the creation of a new institution. Instead, it could take the form of an emergency financing mechanism which is run by the EU Council. Its activation would, however, for political reasons necessitate unanimity as is the case in the existing EFSF (Gros, ó Broin and Kaczyński, 2010).

The recent EU summit agreement on a limited Treaty change gives leeway for deciding about the important details of the new "permanent EFSF". Given that only a few weeks remain until the EC meeting in December and with an eye on the fact that any solution will hinge on Germany's financial contribution, it appears not unlikely that we will see a mere prolongation of the EFSF but with new livery. So this paper buys the view taken by Gros, ó Broin and Kaczyński (2010) that "the new permanent EFSF" will be of a rather *light structure*, probably resembling a 'Berlin Club' as it is currently discussed in German government circles.[6] The task now is to design this structure in such a way as to allow for an orderly sovereign default including the participation of private creditors mentioned in the Council Conclusions. As mentioned above, this is likely to be the most difficult part of the new mechanism. Some sound first proposals in that direction can be found in Gianviti et al. (2010).

Finally, some stylized facts stand out. First, it seems as if the inclusion of collective-action clauses (CACs) in sovereign-bond contracts is target-aimed. Since banks are de facto under government control, gaining a creditor share of 75 percent does not appear to be out of reach in the case of the euro area. Second, a free-will commitment of large investors to stick to and continue to hold their investments in euro area sovereign bonds also in times of crisis is no incentive-compatible and full-fledged alternative. Seen on the whole, thus, the looming institutional follow-up to the EFSF framework does not differ too much from the EMF proposal.

[6] Similar to the informal Paris Club of public lenders at the international stage.

Recently, on November 12, Mrs. Merkel was quoted in the FT as follows: "Let me put it quite simply: in this regard there may be a contradiction between the interests of the financial world and the interests of the political world. … We cannot keep constantly explaining to our voters and our citizens why the taxpayer should bear the cost of certain risks and not those people who have earned a lot of money from taking those risks." Whereas this appears to be substantially correct, this is the variant of issue which should preferably be clarified when there is no crisis. For twelve years now, especially German officials continued to deny that crises of this nature could ever happen. This means that the *clarification of the "no bail-out" principle* has now become the fundamental *cause of the bond market crisis*. Investors have hitherto acted based on the view of a *shared euro area default risk* which has clearly aggravated the debt crisis. Hence, the final recommendation by this paper is that rating agencies should be forced go for stand-alone ratings.

6. Stand-alone ratings for countries – remedial action in case of market failure

Last week, the EU Commission has published a consultation note addressing the further procedure with respect to rating agencies. The deadline for answers will be January 7, 2011. Also the IMF has devoted a complete chapter of its recent Financial Stability Report to the rating agencies. The assessment of the PIGS states by rating agencies has up to now been severely misguided, insofar as a bail-out of these countries by the euro area was factored in. Any country rating without the inclusion of external assistance would be much more transparent. Such "stand-alone-ratings" are endowed with a couple of advantages: they are more precise, they allow for a responsive price setting and they provide quality criteria concerning the evaluation of government's work. Furthermore, "stand-alone-ratings" make it possible to derive more accurate assessments of the present value of the explicit and implicit assumptions of liability for the respective countries (Belke and Burghof, 2010).

The recent and still ongoing euro area debt crisis and its provisional (pseudo-) solution by this year's 9/10 May rescue measures has revealed not only obvious elements of state failure – in particular the failure of the disciplinary devices of the EU – but also a significant dimension of market failure. If the markets had assessed the creditworthiness of certain countries more realistically, the apparent convergence of interest rates could have been avoided. This convergence had originally been the core objective of the creation of EMU. However, it was achieved by the - originally not at all intended - de facto abrogation of the 'no bail-out' clause. This had devastating consequences, as the acute EU-debt crisis with its flickering sovereign bond spreads has impressively shown.

Interest rates: here too low, there too high

The currently growing divergence of government bond yields in the euro area clearly reveals that yields on German government bonds were too high and yields on PIGS bonds were too low over an extended period in the past. Market participants throughout relied on the political fiction that one could and would not let fall any euro area member country. Hence, potential savior countries such as Germany were forced to pay higher borrowing costs since markets anticipated that they would not only be destined to bail out the weaker countries but in the end also potentially had to save some of the savior countries. Countries like Portugal or Greece, in turn, benefited from too low real interest rates which led to excessive consumption, rapidly rising wages, falling competitiveness, higher trade balance deficits and, eventually, to a high private and public indebtedness. Notwithstanding Ireland and Spain where too low real interest rates fueled asset price bubbles. The consequences are well known by now.

If interest rates had been allowed to diverge to a stronger extent, this would have provided incentives for euro area countries to optimize their budgetary policy risk-opportunity profile. However, this does not mean that all countries should have aimed at comparable debt ratios. Instead, more risky strategies such as going for debt financed domestic demand should have resulted in higher risk premia, though. Above all, the respective countries would have been forced to find creditors who consider those strategies as reliable, independent from the existence of cross-national rescue mechanisms. What is more, the time frame of governments which pursue these kinds of strategies would have been shortened significantly. With an eye on the myopia which is typical of governments permanently striving for the retention of power, this would have been particularly valuable for the containment of an excessive debt policy (Belke and Burghof, 2010).

Conceived vs. real solidarity

Rating agencies play a crucial role in determining market assessments. Weaker EU countries received excellent ratings since they belong(ed) to an implicit community of solidarity. Although it had become apparent for a long time that, for instance, neither Portugal nor Greece was able to keep its domestic capital stock constant by concentrating on domestic savings, both countries were downgraded much too late by the agencies. With an eye on the fact that those economies slipped downwards only gradually and, finally, were on the brink of insolvency, such a rating pattern seems neither appropriate, i.e. true-to-fact, nor responsible. The same is valid for Ireland and Spain. Their problems erupted after the burst of the housing bubble but had - as is by now well-known – also cumulated in a stepwise fashion.

Basically, it appears to be legitimate to consider the construct of a conceived solidary group in the overall rating score, since investors, who are interested in the aggregated default risk, are addressed by credit ratings. In the case of the euro area, it proved to be a proper assumption to consider this solidary group. However, there are several reasons which support the claim that rating agencies should provide and also publish, in addition to the aggregated ratings, a stand-alone-rating which does not account for possible financial support of third parties in the assessment of the creditworthiness of countries (Belke and Burghof, 2010).

Stand-alone-rating: few additional costs, much more precision

The necessary information should be already available to the rating agencies. Thus, there would be little additional costs. In general, the assessment of the creditworthiness relies as a first step on the isolated evaluation of a single entity. This evaluation is modified not earlier than in a second step according to collateral and liability relations.

Stand-alone-ratings may provide information revealing only limited relevance for investors, but with a crucially higher precision. The isolated analysis of the creditworthiness of a country based on available data on the budgetary stance, economic power and other fundamental conditions is a core competence of rating agencies. However, the question whether a rescue package is prepared and delivered by a third party, is beyond their reach and will be answered in the political sphere. Any forecast in that respect is subject to great uncertainty. Whether rating agencies really perform better in this business than others such as, for instance, investors appears doubtful at least.

A central argument in favour of stand-alone-ratings is that they represent an important source of information for a more differentiated market perception and a correspondingly more responsive pricing. A failed government budget policy as a rule leads to higher interest rates and thus to a rapid restriction of the scope of action of the government. Hence, stand-alone ratings can help to foster the allocation function of the capital market (Belke and Burghof, 2010).

Stand-alone-ratings also offer the voters important pieces of information about the quality of their government – a welcome corrective device in times of too frequent short-term orientation of economic policy before election dates. Finally, the comparison of the stand-alone rating and the aggregated rating allows to asses and quantify the value of implicit and explicit assumptions of liability for the respective country. Obviously, keeping quiet about information related to stand-alone ratings of countries does not serve the common welfare, although, or even because this information is uncomfortable or even inconvenient for governments, and might cause them major problems.

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